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TAX REFORM ACT OF 1969

H.R. 13270

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PART B—ADDITIONAL STATEMENTS

(Topics: General; Farm Losses; Cooperatives)

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

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STATEMENT BY GEORGE MEANY, PRESIDENT,
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS,
BEFORE THE SENATE FINANCE COMMITTEE,
ON THE TAX REFORM ACT OF 1969, H. R. 13270.

September 22, 1969

My name is George Meany and I am president of the American Federation of Labor and Congress of Industrial Organizations.

The 13.5 million members of the unions of the AFL-CIO are, almost without exception, taxpayers. They pay their taxes regularly, payday after payday, through the payroll withholding program. They are loyal Americans; they appreciate the value of government, the services of government, the need for paying for government.

They are willing to pay their fair share.

But they are tired of having to pay the share of other Americans. Specifically, they are tired of paying the share of those Americans whose incomes are greater and whose taxes are lower -- the "loophole set" in today's society.

So it is on behalf of the largest organized group of taxpayers in America that the AFL-CIO appears here today as advocates of tax justice. We don't have tax justice today and will not achieve it under the House bill. And the Administration's proposals bear no resemblance at all to tax justice.

The federal tax system is rigged against those whose livelihood comes from the work they do. It is rigged in favor of those whose income results from investments.

This unfair rigging results from the fact that a triple standard is applied to income taxed by the federal government.

One standard applies to wages, salaries, and other forms of so-called ordinary income. This income is taxed in full and, for workers, the tax is regularly deducted from their paychecks.

A second standard applies to income from stocks, real estate, and other so-called capital assets sold at a profit. Only half of such income is taxed.

And under present law the tax can never be more than 25% -- even for those in the very top tax brackets.

A third standard is applied to certain forms of income which never even appear on the tax form, such as the interest on state and local bonds, or the income that is washed out by phantom, nonexistent costs as oil depletion, fast depreciation write-offs, and bookkeeping farm losses. This type of income completely escapes taxation.

The wealthier you are, the greater are the opportunities to take advantage of these preferentially taxed or untaxed forms of income.

This triple standard will not be ended through reforms that eliminate or curb some relatively obscure tax dodges affecting a handful of people. Nor will it be ended merely by ensuring that those of extreme wealth and ability-to-pay are called upon to make some contribution to the federal Treasury.

The now infamous 21 persons, for example, who paid no taxes at all on their incomes of $1 million and over, have become a symbol. And, I fear, too many have addressed themselves only to this symbol. Tax measures to ensure that those with astronomically high incomes merely pay some taxes to the federal government falls far short of tax justice.

Justice can only come when:

*The completely impoverished are removed from the tax rolls.

*There is a meaningful reduction in the relative tax burdens of low and middle-income families.

*The loopholes of special tax privilege for wealthy families and businesses are eliminated.

The single most costly loophole and the one that is the prime culprit of unfairness is the capital-gains loophole.

This is not a loophole which applies only to a handful. It is not a loophole which reduces anyone's taxes to zero. And its effect on the tax structure does not give rise to tax-evasion horror stories that can be dramatically illustrated through the media.

Yet, because of the half tax on capital gains and the zero tax on such gains passed on at death, some $30-40 billion escapes the tax base, resulting in an annual Treasury revenue loss of over $10 billion.

And it is a tax preference that says, in effect, the more wealth and income you have, the more opportunities you should be allowed to avoid a fair share of taxes.

The AFL-CIO has continually pointed to this loophole as the major flaw in the tax system. The Treasury study published last February confirms this, saying that the special treatment accorded capital gains is the "most important factor in reducing the tax rates of those with high incomes."

We see no justice to a tax provision which says that a married taxpayer with $8,000 in capital-gains income should pay a tax of $354 while a married taxpayer, with the same amount of wage income, should pay $1,000.

We also recommend taxation of the $15 billion in capital gains that is passed on annually to heirs without even being mentioned on the income-tax form.

Under the House action, some of the capital-gains loopholes would be trimmed. The House would eliminate the 25% maximum and would extend the holding period for long-term capital gains from six months to one year.

Even with these improvements, capital gains would still remain as the prime factor in eroding the fairness of the tax structure, for unearned income would still be preferentially taxed. And, what is worse the Administration has proposed to weaken even these modest reforms.

If the tax structure is to meet America's standards of fair play, loophole closing must be broad-gauged and substantial. On April 1, 1969, before the House Ways and Means Committee, the AFL-CIO presented a program which we believe would achieve tax justice -- a program which would generate some $15-17 billion in federal revenues from substantial loophole-closing, provide relief to those of low and moderate and middle incomes, and allow some $8-10 billion to fully fund existing federal programs geared to meeting domestic needs.

Against that background, we think the House bill merits commendation, for:

1. The working poor are relieved of any federal tax obligation.

2. The hard-working, tax-paying low-and middle-income Americans, who have been forced to bear far more than their just share of the tax burden, have been given a modicum of relief.

3. The single most inflationary pressure in the economy, the 7% investment credit to business, has been eliminated.

4. Some of the loopholes and gimmicks in the tax structure, designed to provide special, unfair tax bonanzas for the very wealthy, have been trimmed, although not eliminated.

We urge the Senate to improve upon the House action and to reject all proposals, including those of the Administration, which would move the tax structure

still further away from America's standards of fair play.

Specifically, we urge the Senate to:

1. Close the capital-gains loophole, ending the major tax preference for unearned income.

There cannot be tax justice as long as unearned income is half-taxed while earned income is taxed in full.

The modest changes recommended by the House are welcome but not enough and the Administration would largely undo the positive action taken by the House.

2. Put an end to the tax abuses of the oil, gas and other mineral industries.

Again the measures taken by the House are welcome ones. They would reduce the depletion allowance, eliminate depletion on foreign oil and gas wells, place a limit on the amount of exploration expenses that can be immediately written off, and end some other abuses such as the carved-out production payment.

Nevertheless, of the total revenue that escapes taxation due to the activities of these industries, only one-third would be recovered by the House action.

We recommend the complete elimination of these abuses.

3. Eliminate the maximum-tax provision

Under the maximum-tax provision contained in the House bill the top tax rate on earned income would be 50%.

This proposal would benefit only those with incomes above $50,000.

It would serve to provide an uncalled-for tax bonanza of $100 million to top corporate executives, doctors, lawyers and others whose income comes from astronomically high fees and salaries.

The Administration has strongly endorsed this proposal. It reflects a cynical philosophy that if taxes on the wealthy are cut, they won't try so hard to find loopholes. Such a philosophy makes a mockery of tax-reform efforts. We cannot subscribe to it and we strongly condemn it.

4. Strengthen the minimum-tax provisions of the House bill.

The so-called Limit on Tax Preferences (L.T.P.) proposed by the House and the weaker version offered by the Administration are prime examples of reforms addressed solely to symbols.

Both the House and the Administration versions would limit the amount of certain types of income that can be completely tax-exempt to no more than half of total income plus $10,000. Thus, the more the income you have, the more can be tax-free.

What's more, if you fail to shelter all your income in one year, you can keep trying for another five.

Under the House bill, though a wealthy individual affected by the L.T.P. would by no means pay his fair share of taxes, he would pay some.

Under the Administration proposals, since state and local bond interest would not be recognized as income under the L.T.P., some wealthy individuals would still escape scot-free and pay no taxes at all.

The AFL-CIO has proposed a 25% minimum tax on exempt income in excess of $10,000 for individuals and $25,000 for corporations -- regardless of the amount of the taxpayer's ordinary income.

5. Strengthen and improve other measures contained in the House bill.

For example:

-Interest on state and local bonds should be taxed in full with the federal government guaranteeing the bonds and providing an interest subsidy to ensure that the fiscal powers of the state and local governments are not damaged.

-Instead of the Hobby Farm loophole-closing proposals suggested by the House and the Administration, the loss-limit approach contained in S.500 should be adopted.

This procedure was recommended by Senator Metcalf and endorsed by a bipartisan group of 26 Senators. This approach is specifically tailored to the tax-loss farmer and ensures that legitimate farm operators will not be penalized.

- The income-averaging formula should not be liberalized to include capital gains unless the preferential treatment accorded such gains is eliminated.

- Interest deductions on bonds used to finance corporate mergers and acquisitions should be completely disallowed.

- All rapid depreciation on real estate should be disallowed, except for low- and moderate-income housing.

- Accelerated depreciation on regulated utilities should not be allowed unless the tax benefits flow through to the consumer.

Finally, the Senate should provide more substantive relief to those whose incomes are moderate and whose tax burdens are unnecessarily severe.

Tax relief and tax justice do not necessarily go hand-in-hand. The equity in the tax structure can be as badly damaged by tax cuts as it can by tax increases or the addition of new loopholes and gimmicks.

Under the House-passed bill this concept was partially recognized. Though all groups would receive relief, a significant proportion of the relief would flow to low- and middle-income taxpayers.

Under the changes proposed by the Administration needed relief for those just above the government-defined poverty threshold and those in the middle-income brackets would be cut back, the state-gasoline-tax deduction would be disallowed, and a tax cut would be given to corporations.

Under the House proposals, $4 billion in tax relief is provided through the low income allowance and standard deduction increases. These primarily benefit low and middle income taxpayers. Another $4.5 billion is granted through across-the-board rate cuts. Over half of this relief goes to taxpayers with incomes of $15,000 or over.

The Administration agrees with the House on cutting the taxes of the wealthy, but says it goes too far when it would cut taxes for those of low and modest incomes. In addition, claims the Treasury, corporate taxes should be cut $1.6 billion.

We endorse the House proposals to increase the low-income allowance to a flat $1,100. In addition, we endorse the House proposals to increase the standard deduction to 15% and $2,000.

We do not agree with the general rate reductions recommended by the House and the Administration; and certainly there is no justification for a reduction in corporate taxes.

Instead we recommend a reduction in the tax rates that apply to the first $8,000 of everyone's taxable income for married individuals and the first $4,000 for single individuals.

The rate changes we propose and their effect are shown on the attached tables.

Our relief proposals would result in the same revenue loss as that proposed by the House. They would cost roughly $600 million more than proposed by the Administration -- an amount that could easily be made up by, for example, eliminating the maximum-tax provision, effectively closing the hobby-farm gimmick, and adopting a meaningful minimum tax.

Mr. Chairman, we urge that this committee bring the federal income tax into line with what it's supposed to do --tax income in accordance with ability-to-pay. That's tax justice.

Table I

AFL-CIO PROPOSED CHANGES IN INCOME TAX RATES

The rate changes would be as follows:

The 14% rate should be cut to 9%
The 15% rate should be cut to 13%
The 16% rate should be cut to 15%
The 17% rate should be cut to 16%
The 19% rate should be cut to 18%

All other rates would remain the same.

Under this procedure, every taxpayer would receive a tax reduction. But, the individual with a taxable income of $100,000 would get the same tax break as the $8,000 man. With the rate structure recommended by the House, a married individual whose taxable income is $100,000 would receive a $3,600 cut while the $8,000 married individual would have his taxes reduced by only $80. Under the AFL-CIO proposal both would receive a cut of $130.

Table II

FEDERAL INCOME TAX BURDEN

Present Law Compared With House Reform Bill, Treasury Proposals, and AFL-CIO Proposals
Married Couple, 2 Dependents

Wage or Salary Income	Total Tax: Present Law	Total Tax: House Reform Bill	Total Tax: Treasury Proposals	Total Tax: AFL-CIO Proposals	Tax Reduction: House	Tax Reduction: Treasury	Tax Reduction: AFL-CIO
$3,000	0	0	0	0	-	-	-
4,000	$ 140	$ 65	$ 81	$ 45	$75	$59	$95
5,000	290	200	253	155	90	37	135
7,500	687	576	616	526	111	71	161
10,000	1,114	958	1,012	908	156	102	206
12,500	1,567	1,347	1,447	1,300	220	120	267
15,000	2,062	1,846	1,951	1,822	216	111	240
20,000	3,160	2,968	2,968	3,030	192	192	130
25,000	4,412	4,170	4,170	4,282	242	242	130
50,000	13,388	12,604	12,604	13,258	784	784	130
100,000	37,748	34,892	34,892	37,618	2,856	2,856	130

Assumes deductions equal to 10% of income, minimum standard deduction (low income allowance) or standard deduction -- whichever is greater. Table takes into account the rate cutting, standard-deduction changes, and low-income allowance proposed by the House, the Treasury and the AFL-CIO. Surtax excluded.

AFL-CIO Research Department
September 1969

STATEMENT BY GEORGE MEANY, PRESIDENT,
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS,
ON TAX REFORM BEFORE THE SENATE COMMITTEE ON FINANCE.

September 22, 1969

The federal income tax structure is unjust. Events of recent months have made this fact increasingly clear to all reasonably informed citizens.

In 1967, the most recent date for available information, the taxes paid by millionaires averaged only 25% of their total income. Twenty-one of these millionaires and 134 other persons whose reported incomes exceeded $200,000 paid not one cent in federal income taxes.

In that same year, 2¼ million taxpayers whose incomes fell below the government's definition of poverty paid $100 million in income taxes. And the married wage earner, with an income of $8,000, paid $1,000 in income taxes -- 12½ percent.

The federal tax structure is rigged against wages and salaries -- against income from work. It is rigged in favor of unearned income.

This unfair rigging results from the fact that a triple standard is applied to income taxed by the federal government.

One standard applies to wages, salaries and other forms of so-called ordinary income. This income is taxed in full, and for workers the tax is regularly deducted through payroll withholding.

A second standard applies to income from stocks, real estate and other so-called capital assets sold at a profit. Only half of such income is taxed. And under present law the tax can never be more than 25% -- even for those in the very top tax brackets.

A third standard is applied to certain forms of income which never even appear on the tax form, such as the interest on state and local bonds or the income that is washed out by phantom, nonexistent costs as oil depletion, fast depreciation write-offs, and bookkeeping farm losses. This type of income completely escapes taxation.

Thus:

* Income gains from the sale of stock or other property, held for more than six months, are taxed at only half the regular tax rate -- with a top maximum rate of 25%. Moreover, when stock or other property is passed on to heirs at death, the increased value of the property from the date of purchase is not subject even to this much-reduced capital gains tax.

* Income from interest payments on state and local bonds is completely exempt from federal taxation.

* Sizable portions of the income from oil and gas properties and a large number of minerals never enter the tax stream because nonexistent "depletion" expenses are written off.

* Much of the income from real estate escapes taxation since it is written off as depreciation. Such income is not only exempt from taxation but, since it is considered a write-off cost, it provides an additional tax shelter for the wealthy because it is deducted from other taxable income.

* Because of the little-known unlimited-charitable-contribution-deduction special privilege, many wealthy individuals and businesses use the disguise of philanthropy to avoid paying any tax at all.

* Tax-exempt family foundations can be set up so wealthy families can control their fortunes in perpetuity without paying taxes.

* Wealthy nonfarmers can invest in farm operations which yield imaginary losses that can be charged off against their high nonfarm incomes.

* Business deducts 7% of the cost of new equipment and machinery from its tax bill -- as a special tax credit. And, they can deduct it again as part of depreciation.

As a result of these and other inequities, an unduly large part of the burden of running the federal government is heaped upon the shoulders of those who can afford it least.

These facts are generally known. They are causing an alarming erosion of public confidence in the tax structure and in the fairness of the federal government as well. And since Americans expect so much from their tax structure -- national defense, public facilities and services, grants-in-aid to the states and local governments -- these inequities in the tax structure undermine public support for much-needed expansion of government services -- federal, state and local -- for a growing, urban population.

It is for these reasons, the AFL-CIO is seeking tax justice. To us, there is a critical distinction between tax reform and tax justice, and recent events have made it imperative that this distinction be clearly set forth.

The now infamous 21 persons, for example, who paid no taxes at all on their incomes of $1 million and over have become a symbol. And too many have addressed themselves only to this symbol. Tax measures that eliminate or curb some obscure tax dodges or that ensure that those with astronomically high incomes merely pay some taxes to the federal government, fall far short of a just and equitable federal income-tax structure.

Justice can only come about if each taxpayer bears his rightful share of the burden of operating our government.

This will only happen when:

1. The impoverished are completely removed from the tax rolls.

2. There is a meaningful reduction in the relative tax burdens of low- and middle-income families.

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3. The loopholes of special tax privilege for wealthy families and businesses are eliminated.

This is not now the case. Although the situation would improve if the House-passed Tax Reform Act becomes law, justice would still not be achieved. Moreover, the Administration would undo much of the good proposed by the House and would add additional inequities to the tax structure.

A major point here is that there are loopholes and there are loopholes.

There are some, like the unlimited-charitable-contribution gimmick, which enable a handful of multimillionaires to pay little or no taxes even though they make more in a year than the average worker makes in a lifetime.

This type of gimmick is an unconscionable flaw in our tax laws and it lends itself to horror stories of tax avoidance.

It should be ended. Both the House bill and the Administration recommend its termination. Ending it would add a measure of justice to the tax structure. But closing this loophole will do little in the way of eliminating the basic structural flaws in the system that cost billions upon billions in federal revenues and serve to pull the entire structure away from principles of progressive taxation of income based on ability-to-pay.

In contrast, the single most costly loophole and the prime culprit in the unfair way in which our tax system is rigged is the capital-gains loophole.

This is not a loophole which applies only to a handful. It is not a loophole which reduces anyone's taxes to zero. And its effect on the tax structure does not give rise to tax-evasion horror stories that can be dramatically illustrated through the media.

Yet, because of the half tax on capital gains and the zero tax on such gains passed on at death, some $30-40 billion escapes the tax base, resulting in an annual Treasury revenue loss of over $10 billion.

And it is a tax preference that says, in effect, the more wealth and income you have, the more opportunities you should be allowed to avoid a fair share of taxes. Such gains come about through buying stocks, real estate, and other assets cheap and selling them dear. It is therefore a game for those who have wealth.

The effect of the half tax on capital gains on the entire tax structure was made alarmingly clear in the Treasury study presented to the Ways and Means Committee last February. The study showed, for example, that the capital-gains provisions alone compressed the tax-rate schedule down to a point where those with $1 million-and-over annual incomes paid an average tax rate of less than 33%. (See Table 4)

The AFL-CIO has continually pointed to this loophole as the major flaw in our tax system. The Treasury confirms this and claims that the special treatment accorded capital gains is the "most important factor in reducing the tax rates of those with high incomes."

We have proposed the elimination of this loophole. We see no justice to a tax provision which says that a married taxpayer with $8,000 in capital-gains income should pay a tax of $354 while a married taxpayer with the same amount of wage income would be taxed at $1,000.

We have also recommended taxation of the $15 billion in capital gains that is passed on annually to heirs without even being mentioned on the income-tax form.

As a result of the House-passed bill, some of the capital-gains abuses would be trimmed. The House would eliminate the 25% maximum and extend the holding period for long-term capital gains from six months to one year.

Even with these improvements, capital gains would still remain as the prime factor in eroding the fairness of the tax structure, for unearned income would still be preferentially taxed. Moreover, the Administration has proposed to undo even these modest improvements.

Thus, if the tax structure is to meet America's standards of fair play, loophole closing must be broad-gauged and substantial. The gimmicks that give rise to the evasion horror stories must be eliminated, but loophole closing also must be addressed to the costly and disruptive preferences that cause the burden of the federal income tax to fall on those least able to bear it.

On April 1, 1969, before the House Ways and Means Committee the AFL-CIO presented a program which would achieve tax justice -- a program which would generate some $15-17 billion in federal revenues from substantial loophole-closing, provide relief to those of low and moderate and middle incomes, and allow some $8-10 billion to fully fund existing federal programs geared to meeting domestic needs.

The House of Representatives has taken a major step in this direction. Unfortunately it has not gone far enough and the Administration's recommendations, if adopted, would undo many of the forward measures proposed by the House and add additional inequities.

The House tax-reform measure merits commendation, for:

1. The working poor would be relieved of any federal tax obligation -- a measure long sought by the AFL-CIO.

2. The hard-working, tax-paying low- and middle-income Americans, who have been forced to bear far more than their just share of the tax burden, would be given a modicum of relief. This is a move toward a long-time goal of the AFL-CIO.

3. The single most inflationary pressure in the economy -- the 7% investment credit to business -- would be eliminated. The AFL-CIO has always opposed this device.

4. Some of the loopholes and gimmicks in the tax structure, designed to provide special, unfair tax bonanzas for the very wealthy in the nation, would be trimmed, although not eliminated. It has long been the AFL-CIO position that special tax privileges to the few best able to pay their fair share of taxes are completely unfair and must be eliminated. That remains our position.

We urge the Senate to improve upon the House action and to reject all proposals, including those of the Administration, which would move our tax structure still further away from America's standards of fair play.

Specifically, our recommendations are:

1. The Senate should close the capital-gains loophole, ending the major tax preference for unearned income.

The preferential half-tax rate which applies to capital gains and the zero tax that applies to such gains when passed on at death are the most disruptive elements in our tax structure. Indeed, there cannot be tax justice as long as unearned income is half-taxed while earned income is taxed in full.

The modest changes recommended by the House are welcome. Extending the holding period to one year and eliminating the 25% maximum are steps toward justice. Nevertheless the preferential one-half tax would not be changed and the Administration proposals, if adopted, would largely undo the positive action taken by the House.

2. The Senate should put an end to the tax abuses of the oil, gas and other mineral industries.

Again the measures taken by the House are welcome ones. They would reduce the depletion allowance, eliminate depletion on foreign oil and gas wells, place a limit on the amount of exploration expenses that can be immediately written off, and end some other abuses such as the carved-out production payment.

Nevertheless, of the total revenue that escapes taxation due to the activities of these industries, only one-third would be recovered by the House action.

The AFL-CIO recommends the complete elimination of these abuses.

3. The Senate should eliminate the maximum-tax provision.

Under the maximum-tax provision, the top tax rate on ordinary income would be 50%.

This proposal would benefit only those with incomes above $50,000. It would serve to provide an uncalled-for tax bonanza to top corporate executives, doctors, lawyers and others whose income comes from astronomically high fees and salaries.

The Administration has strongly endorsed this proposal. It is a proposal which reflects the cynical philosophy that if you cut the taxes on the wealthy, they won't try so hard to find loopholes. Such a philosophy makes a mockery of tax-reform efforts. We cannot subscribe to it, and we condemn it.

4. The Senate should strengthen the minimum-tax provisions of the House bill.

The so-called Limit on Tax Preferences (L.T.P.) proposed by the House and the weaker version offered by the Administration are prime examples of reforms addressed solely to symbols.

Both the House and the Administration versions would limit the amount of certain types of income that can be completely tax-exempt to no more than half of total income plus $10,000. Thus, the more the income you have, the more can be tax-free.

What's more, the amounts of tax-exempt income disallowed under the L.T.P. formula can be carried forward for five years. In other words, if you fail to shelter all your income in one year, you can keep trying for another five.

Under the House bill, though a wealthy individual taxed under the L.T.P. would by no means pay his fair share of taxes, he would pay some.

Under the Administration proposals, since state and local bond interest would not be recognized as income under the L.T.P., some wealthy individuals would still escape scot-free and pay no taxes at all.

The AFL-CIO proposes a 25% minimum tax on exempt income in excess of $10,000 for individuals and $25,000 for corporations -- regardless of the amount of the taxpayer's ordinary income.

As part of the minimum-tax approach, both the House and the Administration have recommended what is called an Allocation of Deductions provision. Individuals with substantial amounts of tax-free income would be required to allocate itemized personal deductions between tax-free income and taxable income. This is a desirable provision, but various phase-in periods and exceptions recommended by the House and the Administration would blunt its effectiveness. Moreover, neither the House nor the Administration would extend this provision to corporations.

Under present law, those who receive tax-exempt income derive a double benefit. The income never appears on the tax return; hence no tax is paid. Secondly, personal or non-operating business deductions can be deducted in full from taxable income.

The AFL-CIO recommends that before such deductions are permitted, since they are designed to define ability-to-pay, total income (taxable and exempt income) should be taken into account. Thus, individuals with excluded income, as defined below, in excess of $10,000, should be required to allocate certain personal deductions

in line with the ratio their adjusted gross income bears to adjusted gross income <u>plus</u> exempt income. The deductions that should be allocated are: interest and tax payments, casualty losses, charitable contributions, medical expenses, and cooperative housing expenses. Allocation formula should be as follows:

$$\text{Deductions} \times \frac{\text{Adjusted Gross Income}}{\text{AGI Plus Exempt Income Minus \$10,000}} = \text{Allowable Deductions}$$

Excluded income which would cause deduction to be allocated should include the following:

1. One-half of capital gains.
2. State and local bond interest.
3. Depletion taken after the cost of the property has been written off.
4. The difference between the cost and the market value of property donated to charity.
5. Depreciation on real estate taken in excess of straight-line, except for low-and moderate-housing.

Corporations with excluded income, as defined above, in excess of $25,000 should be required to allocate non-operating expense deductions between net profit from operations and excluded income.

The allocation formula should be as follows:

$$\text{Non-operating Deductions} \times \frac{\text{Net Operating Profit}}{\text{Net Operating Profit Plus Exempt Income Minus \$25,000}} = \text{Allowable Non-operating Deductions}$$

The AFL-CIO further recommends that deductions disallowed under the allocation formula should be taken into account under the AFL-CIO proposed minimum tax. The disallowed deductions should be added to the $10,000 ($25,000 for corporations) of exempt income that would not be affected by the minimum tax.

5. <u>The Senate should strengthen and improve other measures contained in the House bill</u>.

For example:

- Interest on state and local bonds should be taxed in full with the federal government guaranteeing the bonds and providing an interest subsidy to assure that the fiscal powers of the state and local governments are not damaged.

- Instead of the Hobby Farm loophole-closing proposals suggested by the House and the Administration, the loss-limit approach contained in S. 500 should be adopted. This procedure was recommended by Senator Metcalf and endorsed by a bipartisan group of 26 Senators. This approach is specifically tailored to the tax-loss farmer and ensures that legitimate farm operators will not be penalized.

- The income-averaging formula should <u>not</u> be liberalized to include capital gains unless the preferential treatment accorded such gains is eliminated.

-Interest deductions on bonds used to finance corporate mergers and acquisitions should be completely disallowed.

- All rapid depreciation on real estate should be disallowed, except for low- and moderate-income housing.

- Accelerated depreciation on regulated utilities should not be allowed unless the tax benefits flow through to the consumer.

Of equal importance, the Senate should provide more substantive relief to those whose incomes are moderate and whose tax burdens are unnecessarily severe.

Tax relief and tax justice do not necessarily go hand-in-hand. The equity in the tax structure can be as badly damaged by tax cuts as it can by tax increases or the addition of new loopholes and gimmicks.

Under the House-passed bill this concept was partially recognized. Though all groups would receive some relief through the combination of changes in the

low-income allowance, the standard deduction and the rate reductions, a significant proportion of the relief recommended by the House would flow to low- and middle-income taxpayers.

Under the changes proposed by the Administration, needed relief for those just above the government-defined poverty threshold and those in the middle-income brackets would be cut back; the state-gasoline-tax deduction would be disallowed, and a tax cut would be given to corporations.

Under the House proposals, $4 billion in tax relief is provided through the low-income allowance and the standard-deduction increases. Another $4.5 billion is granted through rate cuts.

The first two relief proposals -- the low-income allowance and standard-deduction provisions -- provide 90% of the tax relief or $3.6 billion to those with incomes of $15,000 or less. The Administration would cut back on both of these forms of tax relief.

But the House rate cuts which in the main benefit higher income groups would remain intact. Specifically, of the $4.5 billion relief recommended through rate cutting, over half flows to the 10% of taxpayers with incomes of $15,000 or over. On top of this the Administration would provide a $1.6 billion tax cut to corporations.

In basic terms, the Administration agrees with the House when the House wishes to cut the taxes of the wealthy. But the Administration says the House goes too far when it suggests cutting taxes for those of low and modest incomes -- instead, claims the Treasury, corporate taxes should be cut.

We endorse the House proposals to increase the low-income allowance to a flat $1,100. In addition, we endorse the House proposals to increase the standard deduction to 15% and $2,000.

We do not agree with the general rate reductions recommended by the House and the Administration; nor do we feel there is any justification for a reduction in corporate taxes.

Instead of the general rate reductions proposed by the House and the $1.6 billion corporate rate cut, we recommend a reduction in the tax rates that apply to the first $8,000 of everyone's taxable income for married individuals and the first $4,000 for single individuals.

The rate changes would be as follows:

The 14% rate should be cut to 9%.
The 15% rate should be cut to 13%.
The 16% rate should be cut to 15%.
The 17% rate should be cut to 16%.
The 19% rate should be cut to 18%.

All other rates would remain the same.

Under this procedure, every taxpayer would receive a tax reduction. But, the individual with a taxable income of $100,000 would get the same tax break as the $8,000 man. Under the rate structure recommended by the House, a married individual whose taxable income is $100,000 would receive a $3,600 cut while the $8,000 married individual would have his taxes reduced by only $80. The AFL-CIO proposal would grant both a cut of $130 (see Table 2).

Under the AFL-CIO proposals, the net revenue loss would be approximately the same as that proposed by the House [illegible]. It would be roughly $600 million more than proposed by the Administration -- an amount that could easily be made up, for example, by eliminating the maximum-tax provision, effectively closing the hobby-farm gimmick, and adopting a meaningful minimum tax.

We want to reemphasize that the complete loophole-closing programs we have urged would leave many billions of dollars which could be used for funding the social and economic programs which the Congress has enacted in recent years.

The objective of tax justice is an ambitious one. But it is long overdue and critically urgent. There is no longer time for pause, delay, gestures or tokens.

Only twice since its inception in 1913 has the federal tax structure been revised. And these two revisions -- in 1939 and 1954 -- were, according to a former Commissioner of Internal Revenue, only "faceliftings."

The tax system must now provide for the interests and needs of a nation of over 200 million people who are demanding more and better public facilities. Yet many of the flaws that have existed since the federal government first began to tax incomes still exist and many new ones have been added.

The costs of government are not being shared fairly. An unwarrented limitation is placed on the effectiveness of tax policy in promoting broad goals of balanced economic growth and full employment and public confidence is decaying.

When tax revenues are to be spent, the legislative and executive branches appropriately study and evaluate every outlay of public funds to assure that national interests will be forwarded and priorities balanced. Yet, on the revenue-raising side, tax policy is all too frequently considered only in terms of need for more dollars or fewer dollars.

The temporary surtax, adopted in 1968, is a prime example. A flat percentage tax on top of the existing tax is a fair way to divide the burden of an increase in taxes -- but only if the original burden is fair.

Since a tax on a tax cannot be collected if no taxes are paid, those who are rich enough to avoid their fair share of taxes through capital gains, depletion, accelerated depreciation, tax-exempt interest and other tax-escape routes, pay no surtax on such exempt income. Because of this, others pay more and the basic inequities are compounded.

What is more, many of the inequities cause the taxation system to run in direct opposition to the objectives sought through public tax-spending programs.

For example:

* While the nation is being burdened with inflationary pressures and high interest rates, the task of easing these burdens is made more difficult by the tax system. Privileges such as the 7% investment credit and accelerated depreciation on real estate fuel the fires of the only source of inflationary demand in the national economy -- business investment in plants, machines and equipment.

* $935 million in federal funds are being spent on low- and moderate-income housing; yet $800 million worth of tax loopholes go to real-estate operators constructing motels, office buildings, plants and high-rise, high-rent apartment complexes.

* $4.5 billion is spent to "stabilize farm incomes;" yet wealthy nonfarmers are encouraged, through the tax system, to disrupt and distort the farm economy.

* The large and growing concentrations of wealth and economic power are a source of growing national concern; yet the income-tax system allows $15 billion in appreciated assets to accumulate and be transferred to heirs without ever entering the tax base. At the same time, tax-exempt status is given to certain types of family foundations set up for avoiding taxes and perpetuating control of family and industrial financial dynasties. Eight million dollars are spent enforcing antitrust laws; yet the tax system provides incentives for those who would merge and "conglomerate."

* Oil, gas and other depletion allowances are justified largely on the basis of encouraging development of domestic productive capacity; yet similar tax benefits flow to those bolstering the productive capability of foreign nations.

* Some $25 billion in federal categorical grant-in-aid funds will go to the states and localities in 1969; yet the amount of federal money available to hard-pressed state and local governments is diluted by allowing interest on state and local bonds to go tax-free, since this exemption costs the Treasury more than the states and municipalities gain.

* The nation is committed to alleviating the plight of its 25 million poor; yet many of these families today pay federal income taxes while many of the wealthiest legally ignore the federal tax collector.

Though the case for reform is compelling and perhaps conclusively demonstrated by these incongruities and paradoxes, there is another too frequently overlooked aspect.

Federal income taxes are not the only taxes Americans must pay. In fact, though federal income-tax revenues have grown and still loom largest among the taxes paid by most individuals, state and local taxes have grown at a far faster pace. What's more, the increases in state and local taxes have in the main resulted from levies on property and sales to consumers which take their toll from those whose ability to pay taxes is the least.

The 1969 Economic Report of the President showed that the combined federal, state and local tax systems converge in such a manner as to redistribute income "away from the poor." At the same time, those of modest and middle incomes are bearing a disproportionately high share of the tax burden while those with wealth and ability-to-pay escape their fair share.

Thoroughgoing federal income-tax loophole closing and reform would make a substantial contribution toward compensating for the unfair manner in which the burden of other taxes fall.

Furthermore, it is the federal income-tax system that most states look upon as the standard for a good and fair way to allocate the costs of public services. A number of states that do use income taxes use the federal definitions and standards as models for their own systems, and three states now "piggyback" their taxes directly upon the federal taxes that their residents must pay.

Yet, as the inequities in the federal system grow and become more and more notorious, the basic principles of taxation based on income and ability-to-pay become suspect and fair-minded state and local legislators find it increasingly difficult to convince those they represent of the advantages of fair taxation methods.

CLOSING THE LOOPHOLES

Capital Gains

The capital-gains route is, according to the Treasury, the most important factor in reducing the tax rates of those with high incomes.

In examining the tax returns of all those with incomes of over $100,000, the Treasury shows that this group shelters $3.8 billion from the tax base through this loophole -- nine times the amount this group shelters through tax-exempt interest, 36 times the amount this group shelters through the unlimited-charitable-contribution loophole, 54 times the amount this group shelters through tax-loss farming.

Under present law, when certain so-called "capital" assets are sold, the profit is taxed at only one-half the rates that apply to ordinary income. And, the tax rate cannot exceed 25% regardless of the amount of the seller's total income. Capital assets under the Internal Revenue Code consist of property such as corporate stocks, vacant land, and other assets not held for use in the taxpayer's trade or business.

In addition, profits from the sale of many other assets -- although not defined by the Code as capital assets -- can also receive this same privileged preferential tax treatment. Profits from the sale of livestock used for draft, dairy or breeding; real estate used in a trade or business; royalties from sales of timber, iron ore,

and coal deposits can all qualify for the preferential treatment as capital gains as can gains on sales of business machinery and equipment.

What's more, the capital-gains-tax escape route combines neatly with many other avoidance schemes, stimulating their use and compounding the tax benefits. Accelerated depreciation on real estate -- a loophole which permits postponement of taxes and creates opportunities for tax-loss gimmickry -- also paves the way for converting what should be ordinary rental income into capital gains. The depletion allowances for mineral industries, in themselves an unconscionable gimmick for deducting nonexistent expenses, also serve as the vehicle whereby ordinary income is unjustifiably converted to capital gains.

Another major leak in the tax system, according to the Treasury Department, results from the fact that large amounts of capital gains "fall completely outside the income tax system," since capital gains on assets transferred at death or by charitable donation go tax-free. The Treasury estimates that $15 billion of capital gains in 1967 were not taxed at all, through this escape route. If an individual holds an appreciated asset till he dies, the appreciation is not subject to the income tax. If an individual or corporation donates appreciated property to a charitable organization, the appreciation is never taxed -- and the full appreciated value can be deducted from other income.

For example, if a taxpayer donates $1,000 worth of stock which cost him $100, he pays no tax on the $900 of appreciated value and is permitted to deduct the full value ($1,000) from his income. If he were in the 50% bracket,

this gift of an asset which cost him $100 would save him $500 in taxes. If he sold the asset, included half the capital gain in his income, and then contributed the $1,000 in cash, his net tax saving would have been only $275. If the $900 appreciation were taxed at ordinary rates rather than the 25% maximum capital-gains rate, the donation of this asset that cost $100 would have only yielded a net tax saving of $50.

Moreover, under certain circumstances it is possible for an individual to actually improve his after-tax position by giving away rather than selling an asset.

In testifying before the House Ways and Means Committee, Professors Martin David and Roger Miller of the University of Wisconsin said:

> The American public has every right to ask what positive justification exists for the failure to collect $15-20 billion of revenue, for the "tax expenditure" created by the capital gains provisions. No concrete research indicates that this tax expenditure has contributed to our economic growth; no one has defended this system who does not himself have a vested interest in its preservation; any tax lawyer or tax economist will confess that these provisions are the ulcer that is primarily responsible for rotting out the taxing power of our nominal tax rates. The dishonesty sanctioned by the capital gains provisions is the first step to a taxing system, such as Italy's, where it is known that open collusion exists between taxpayers and tax accountants to defraud the government.

The modest reforms recommended by the House are welcome. Extending the holding period to one year and eliminating the 25% maximum are steps toward justice. Nevertheless the preferential one-half tax would not be

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changed nor would gains passed on to heirs be subject to income tax. The Administration proposals, if adopted, would largely undo the positive action taken by the House.

To close this loophole, the AFL-CIO urges adoption of the following proposals:

1. Elimination of preferential tax treatment of capital gains for both individuals and corporations. Such gains should be taxed at regular tax rates. At the same time, the present income-averaging provisions should be broadened to include capital gains.

The approximate revenue gain from the AFL-CIO proposal would be $6-7 billion. The House bill would raise $810 million and the Administration, $600 million.

2. Capital gains on property transferred at death.

All appreciation (difference between original cost and market value) should be taxed in full on transfer at death. The tax rate should apply to all appreciation occurring after date of enactment; one-half the tax rate should apply to all gains occurring between an appropriate date such as January 1, 1950, and the date of enactment.

The tax should be allowed as a deduction for estate-tax purposes. It should not apply on transfers between the decedent and spouse nor to estates valued at less than $60,000.

To prevent "forced" sales of assets, appropriate installment-payment procedures should be adopted.

The approximate revenue gain under the AFL-CIO proposals would be $3-4 billion. Neither the House nor the Administration made proposals in this area.

Depletion

Oil, gas and other mineral-extraction industries are allowed to take deductions for depletion. In principle, depletion for extractive firms is akin to the depreciation allowance taken by other industries and is geared to permit the gradual write-off of capital costs over the life of the investment.

However, the percentage-depletion deduction formula is based on income; it has no relationship to the amount of investment. Moreover, unlike depreciation the annual deduction from income never stops -- it continues even after the cost of the investment has been fully written off.

On top of this, certain exploration and development expenditures are immediately tax-deductible (for other industries such expenditures would have to be amortized over a period of years) which means a major part of the investment of many companies has already been written off -- yet the depletion allowance is not changed.

As a result, according to Treasury estimates, oil, gas and other depletion deductions average twelve times the deduction that would be allowed if the deductions were based on actual costs. In the petroleum industry, for example, 90% of the depletion deductions taken are "excessive." In other words, these firms are legally deducting nonexistent costs.

The percentage-depletion formula allows mineral operators to deduct amounts ranging from 5% (gravel, sand and clay) up to 27.5% (in the case of oil) of the gross income from the property -- regardless of the amount of investment. The amount that can be deducted is limited to 50% of net income which means, in many cases, that only half the net income generated from the property is subject to tax.

In addition, there are other gimmicks used by mineral industries to circumvent the modest limitations that do exist on the depletion deduction. The carved-out production payment, for example, is in actuality a loan. The proceeds, however, are treated as income in the year received, thereby boosting the depletion deduction that can be taken. When paid off, the loan is considered an expense. These transactions are timed to generate tax advantages which the Treasury estimates cost $200 million in lost revenues.

And again, these abuses become magnified and compounded by providing opportunities for individuals, corporations and their stockholders to defer taxes, convert ordinarily taxable income to preferentially taxed capital gains, and traffic in tax-loss gimmickry by writing off imaginary losses against other income.

According to the Treasury, the 1968 revenue loss due to excess percentage depletion and the immediate write-off of development costs was as follows:

Excess depletion:	
to corporations	$1,100 million
to individuals	200 million
Expensing capital costs:	
to corporations	240 million
to individuals	60 million
Total	$1,600 million

The two most frequently offered justifications for the tax incentives granted these industries are: (1) special incentives are needed because these businesses are risky, and (2) these resources must be developed domestically for strategic considerations. Yet, risk is certainly not unique to mineral development and many other industries are as strategic or more so. What's more, the fact that percentage depletion is also allowed to companies developing the mineral capabilities of foreign nations hardly squares with the notion of developing a domestic productive base.

The most dramatic testimonial to the fallacy of these arguments, however, was contained in a study done under contract with the Treasury by the Consad Research Corporation of Pittsburgh. This study viewed the $1.6 billion tax incentive appropriately in terms of a federal subsidy, since this is the amount of tax revenue the nation loses as a result of the special privileges. The study showed that this $1.6 billion subsidy led to additional national mineral resources valued in the market at only $150 million. Every dollar in federal tax forgiveness yielded 9¢ worth of additional reserves.

And, according to the Treasury's analysis of the Consad study, the depletion allowance encourages excessive drilling and inefficient production methods and discourages research into other potential fuel sources.

The House reform measures would reduce the depletion allowance, eliminate depletion on foreign oil and gas wells, place a limit on the amount of exploration expenses that can be immediately written off, and end some other abuses such as the carved-out production payment.

Nevertheless, of the total revenue that escapes taxation due to the activities of these industries, only one-third would be recovered by the House action.

The AFL-CIO recommends that deductions for depletion should not be permitted to be taken after the cost of the property has been fully written off.

The approximate revenue gain under our proposals would be $1.5 billion. The House action and the Administration proposals would raise $600 million.

Interest on State and Local Bonds

The interest paid to holders of state and local bonds is completely tax-exempt and never even appears on the income-tax form.

The Treasury estimates that state and local governments save $1.2 billion in interest expense, since the tax-exempt privilege enabled them to sell these bonds at less than market rates of interest. And the Treasury loses $1.8 billion in revenue. The balance -- $600 million -- goes as tax benefits to the wealthy individuals and commercial banks holding most of the bonds.

Since the Treasury loses more than the state and local governments gain, the tax-exempt privilege is a wasteful, as well as back-door, method of providing aid to state and local governments. Moreover, this tax-free interest erodes the equity of the income-tax system since the tax advantages benefit only the wealthy. The Treasury notes that tax-free income from state and local bonds is the second most important factor (capital gains is first) in reducing the taxes of those individuals with incomes of over $100,000 per year.

In 1968, for example, the average yield on high-grade municipal bonds was 4.51% and top-rate (Aaa) corporate bonds was 6.18%. The tax-exempt status compensates for the lower rate only for those in tax brackets of 27% and higher -- the rates which apply to married persons with taxable incomes in excess of $16,000 per year.

To illustrate, if a married person with taxable income of about $8,000 (22% bracket) bought a high-rated tax-exempt municipal rather than a corporate bond, he would lose $1.67 in interest on every $100 invested and save $1.36 in taxes, suffering a net loss of 31¢ for each $100 invested. On the other hand, for someone in the $100,000-or-over bracket the $1.67 in interest lost saves him $3.83 in taxes -- thus, a net gain of $2.16 on each $100 invested in tax-exempt bonds.

Also the benefits of the tax forgiveness to state and local governments often run counter to the needs and objectives of most subsidies. Since the amount of debt most state and local governments can issue is tied to property values, it is the richer areas of the nation that rely heaviest on debt financing. Thus, the wealthier areas get the largest tax-forgiveness subsidies. Similarly, the bonds issued by the smaller, less affluent governments generally are low- "rated" or not "rated" at all by the investment analysts. Consequently, these bonds are considered riskier and, if they are to compete in the bond market, the poorer governments must bear higher interest costs.

On top of this, there has been a rapid growth in the proportion of municipal bonds held by commercial banks. In 1961 these banks purchased 56% of the state and local debt, and in 1967 roughly 90% of the net purchases were attributed to commercial banks. This has resulted in an erratic market for municipal securities, since these banks switch their investment portfolios back and forth in response to demand for business loans.

In times of tight money and rising business loans, commercial banks reduce purchases of municipals and may, in fact, sell them, thereby limiting the market and driving up the interest rates that municipalities must pay. Such developments require states and localities to pay higher and higher interest rates, in order to market their bonds.

A June 1968 study by the Federal Reserve Bank of Philadelphia notes: many bankers have "... begun to view municipals as a secondary reserve subject to liquidation when funds are needed for other purposes." A year later <u>Business Week</u> magazine stated: "Indeed, municipal bond rates have been streaking up for weeks as commercial banks turned from major buyers of tax-exempt issues into substantial sellers."

Hence, in many ways the interest rates a municipality must pay on its debt (and the amounts of taxes its citizens must pay as a result) are at the mercy of the commercial banks and the bond raters.

What's more, many state and local governments have abused the tax-exempt privilege by issuing so-called industrial development bonds. These tax-exempt bonds have been used to build factories for private industry -- sometimes to the corporations' exact specifications. In this manner, a number of states have pirated firms from other areas, using their federal subsidy for the private benefit of wealthy corporations.

Under the Tax Reform Act passed by the House, state and local governments would be given a choice between floating taxable or tax-exempt bonds. If they choose the former, they will receive a federal subsidy.

The Administration is against this proposal.

The AFL-CIO recommends that all interest on state and local debt securities issued after the date of enactment (following an appropriate transition period) should be subject to the income tax. The federal government should guarantee the bonds and pay the issuing state or local government an amount equal to one-third of the interest cost on such taxable issues. No federal guarantee or interest-rate subsidy should be permitted for industrial development bonds, regardless of the amount of the issue.

There would be a net revenue gain, after taking into account the cost of the subsidy and the guarantee, of approximately $100 million under our proposal. The net revenue gain under the House proposal would be small. The Administration would keep the present system.

Real Estate

A host of special tax-forgiveness provisions apply to real estate. Taken by themselves, these privileges are hardly justifiable but, when manipulated and

combined, they result in unconscionable tax-avoidance opportunities for wealthy real-estate operators, investors, and speculators.

The major tax-escape route is the special accelerated-depreciation deduction. Under these fast write-off formulas, the cost of new buildings can be deducted from income at twice normal or "straight-line rates" and the cost of used buildings can be charged off at 1½ times normal depreciation rates. In the case of a new building with a 40-year estimated life, the result is that about 23% of its cost can be deducted from income during the first five years of the property's life. For a used building, 17% of the investment can be written off in the first five years.

The following table shows the effects of the special depreciation formulas compared to the "straight-line" method which apportions the depreciation deduction equally over the useful life of the asset:

	Building With a 40-Year Life			
	Straight-Line	200%-Declining-Balance	Sum-of-the-Years-Digits	150%-Declining-Balance
1-Yr. Total	2.5%	5.0%	4.8%	3.7%
2-Yr. Total	5.0%	9.8%	9.6%	7.4%
3-Yr. Total	7.5%	14.3%	14.3%	10.8%
4-Yr. Total	10.0%	18.5%	18.6%	14.2%
5-Yr. Total	12.5%	22.6%	23.2%	17.4%
10-Yr. Total	25.0%	40.1%	43.3%	31.7%
20-Yr. Total	50.0%	64.0%	74.4%	53.4%

Since depreciation write-offs are considered a cost, these fast write-offs and other costs are subtracted from rental income and the income tax, if any, is paid on the remainder. Often there is no income at all, or even a reported loss in the early years of ownership, as a result of accelerated depreciation.

Technically, the fast write-off provisions mean that tax liabilities are deferred -- in principle, the lower taxes in the early life, due to excess deductions, will be made up later, as smaller deductions are permitted. To this extent, the excess depreciation results in an interest-free, no-strings federal loan to the real-estate operator.

But the accelerated-depreciation special privilege also paves the way for other tax gimmickry. First, a good part of the excessive depreciation deductions are never returned to the tax base, because the property is sold long before the depreciation deduction runs out. And a good part of that which is eventually taxed is taxed at only half the usual rate, and never more than 25%, since it is considered a capital gain.

Combining these advantages with "leverage" -- much debt, little equity -- the infamous real-estate tax shelter is created. The excessive depreciation plus interest charges on the debt result in large bookkeeping tax losses. These phantom losses are in turn washed out against an individual's other income, sheltering it from the federal tax. To take full advantage of this, many high-income individuals join together into syndicates. These syndicates buy or develop high-depreciation property that will show a loss which can be applied to the wealthy investors' other income. What's more, when the properties approach a point when a profit might be shown (depreciation and interest become less than rental income), the property is then sold or refinanced, starting the cycle all over again.

A Treasury study of 19 investors, exploiting the real-estate shelter, showed that the group had a combined income of $2.7 million from their major economic activities. But, since they made investments in real estate, they were able to "shelter" (remove from their otherwise taxable income) $1.5 million and cut their tax bill by more than half.

The average investor in this group, according to the Treasury, had an income of $141,000 from his other interests. He sheltered $77,500 of this from the Internal Revenue Service by his real-estate investments, and his paper real-estate "losses" saved him $45,000 in taxes.

The Treasury also traced the activities of one real-estate investor over a seven-year period. This operator had a seven-year income of over $7.5 million. Yet, because of real-estate depreciation deductions, he paid the same effective tax rate on his total income as a married wage earner with two children and an annual income of $10,000.

Moreover, real-estate operators can unfairly lighten their share of taxes through reporting capital gains in installments, exchanging appreciated property tax-free, and through complicated mortgage-refinancing arrangements. Again, these are all games open only to those with wealth. And, this real-estate gimmickry:

1. Costs hundreds of millions of dollars in terms of federal revenues foregone -- expenditures or subsidies granted through the tax system. Non-housing, fast depreciation, alone, accounts for a revenue loss of $960 million.

2. Runs in direct opposition to meeting one of our most serious national needs. These privileges serve to channel resources into luxury housing and away from the much-needed improvements and additions to the housing available for those with low and moderate incomes. The Treasury estimates that, of the total tax benefits flowing to real-estate operators, only $50 million went to those investing in low- and moderate-incomes facilities.

The House bill would limit double depreciation to residential property. Depreciation write-offs for commercial and industrial real estate would be limited to 150% of normal. The House bill provides a five-year write-off for expenditures for the rehabilitation of buildings for low-cost rental housing. The Administration supports the House proposals.

The AFL-CIO recommends that all depreciation in excess of straight-line should be disallowed on all real estate except low- and moderate-housing.

Approximate revenue gain, under the AFL-CIO proposal would be approximately $1.5 billion. The House and Administration proposals would raise about $1 billion.

Tax Havens for Wealthy Farm Investors

Under the Internal Revenue Code there are special tax-accounting privileges for farmers -- privileges which were developed to ease the bookkeeping chores of ordinary farmers.

However, these accounting privileges are being manipulated to provide windfall tax benefits to wealthy individuals and corporations who operate or invest in farms in order to get tax losses. These losses are not true losses; nevertheless they can be deducted from the wealthy investor's nonfarm income, sheltering it from the federal income tax.

Though most businesses use the "accrual" method of accounting, since it is the most accurate way to reflect the true income of the business, farmers are permitted to choose between use of the accrual method or the "cash" method. Using the cash method, inventories are ignored. The growth in inventories is not balanced off against other costs. Put another way, costs that reflect the building up of an asset (inventories) are deducted from otherwise taxable income, but there is no corresponding adjustments made for increase in the value of the asset (inventory). As a result, certain farm operators abuse this privilege by carefully mismatching costs and the income generated by these costs, to their tax advantage.

Losses, which under normal (accrual) accounting procedures would result in gains, are created which, in turn, are used to "shelter" the wealthy investor's nonfarm income from his taxable income.

What's more, since many of these "paper" losses actually reflect increases in investment, income taxes that should be paid annually at ordinary rates are postponed until the sale of the inventory at which time the tax is cut in half because capital-gains rates apply. Under these circumstances it is possible for the tax-deductible costs of raising an animal to exceed the taxable gain even though the animal is sold at a profit.

For example, a cash-basis farmer spends $200 over a three-year period in raising a cow and charges the $200 off over the period as an expense. He then sells the cow for $250. His real profit on the transaction was $50; yet, since the entire $250 is considered as capital gains, only half of the $250 ($125) must be reported as taxable income. As a result, he reports $125 in income and deducts $200 in expenses over the three-year period -- his tax returns show a $75 loss on a transaction which in actuality yielded a profit of $50.

Under normal accounting techniques, the $200 spent in raising the cow would have been treated as an increase in inventory and would not have resulted in a deductible expense. Upon the sale of the cow, the capital gain would have been $50 and one-half of it, or $25, would enter his taxable income. Hence the "accrual" farmer would have reported $25 in income (although it was really $50) and no deductions. The "cash" farmer reported income of $125 and expenses of $200.

Moreover, the definition of what are capital assets (and therefore subject to capital-gains tax rates) is stretched considerably, to the advantage of certain farmers. The Internal Revenue Code, for example, treats livestock used for draft, dairy or breeding purposes as depreciable capital assets.

Through the use of "leveraging" (much borrowing -- little cash investment), the advantages of these special privileges are compounded. The combined effects of interest charges on the money borrowed for the farm investment and the operating

losses, that are so easily shown through cash accounting, result in phenomenal phantom tax losses, which are washed out against the other income of wealthy farm investors, sheltering it from taxation.

Some insight into how these special privileges are utilized by the wealthy can be found in the annual income-tax return data published by the Internal Revenue Service.

In 1967, for example, there were over 1 million tax returns filed showing net farm losses, and almost 2 million reporting a net gain. For those taxpayers with adjusted gross income under $50,000, the number of returns showing profits from farm operations exceeded the number showing losses, by rather substantial amounts. The overwhelming majority of actual, operating farmers were in this group.

However, where adjusted gross incomes were over $50,000, more returns showed losses than gains. In the $1,000,000-and-over income group, only 12 returns showed profits -- totaling $74,000 -- compared to 101 returns claiming losses -- totaling $7.6 million. (See Table 5.)

Obviously, "nonfarmers" are investing in farms solely for tax purposes. As a consequence, these nonfarmers compete unfairly with legitimate farmers. They distort the farm economy by bidding up the price of farmland and forcing ordinary farmers to compete in the market with those who are totally indifferent to whether they receive a fair price for the product or not.

The Treasury estimates an annual tax loss of some $800 million due to the farm loopholes. By placing a $15,000 limit, just on the amount of phantom tax loss that can be applied against other income, some $145,000,000 in revenue could be recouped.

Both the House and the Administration recommend trimming this abuse.

Though the Administration would go further than the House, the basic approach is the same and little would be done to curb the tax-loss farm abuses. What's more, under the House and Administration recommendations there is a possibility that some legitimate farmers would be penalized.

The AFL-CIO recommends enactment of the loss-limit approach contained in S. 500. This procedure was recommended by Senator Metcalf and endorsed by a bipartisan group of 26 Senators. This approach is specifically tailored to the tax-loss farmer and ensures that legitimate farm operators will not be penalized.

Under this approach, each dollar of nonfarm income over $15,000 would reduce the amount of farm loss that can be deducted from nonfarm income by $1. This provision would not apply to farm losses resulting from taxes, interest, casualty, drought, and sale of farm property. This provision would not apply to farmers using the accrual method of accounting.

The approximate revenue gain under our proposal would be $145 million. The House would raise $20 million; the administration $50 million.

Tax-Exempt Foundations

The tax-exempt status granted to certain foundations represents one of the most glaring examples of how a well-intentioned, seemingly desirable, tax privilege can become twisted.

As a nation, we recognize that philanthropy is desirable and it should be encouraged. In line with this reasoning, individuals are permitted, within certain limits, to deduct from their taxable income, contributions to organizations established for religious, charitable, scientific, educational and similar purposes. Likewise, the federal government grants tax-exempt status to the organizations receiving the contributions.

Granting special tax privileges for such contributions or to such institutions raises the same fundamental question as in all tax-forgiveness schemes. The government is relinquishing funds it would otherwise be entitled to, and therefore others must pay a higher share of the costs of government. Thus, where there is tax forgiveness, there must also be an assurance that the nation's interests are being served.

Recent investigations into certain tax-exempt foundations -- non-profit organizations set up and supported by wealthy families or individuals -- have raised some serious doubts as to whether appropriate purposes are in fact being fulfilled and the nation's interest is being served.

Tax-exempt foundations have grown phenomenally -- new ones are cropping up at the rate of some 2,000 per year. The assets of the larger foundations have recently been estimated at some $20 billion, and each of the 27 largest foundations has assets worth $100 million or more.

The philosophy underlying the private foundations, according to a foundation spokesman is "the systematic use of private funds for public purposes." Unfortunately, the studies of the activities of tax-exempt foundations done by the House Committee on Small Business have shown that in many cases the opposite situation prevails. That is, public funds are being systematically used for private purposes.

Family foundations frequently are used as a means whereby the wealthy can avoid income, gift and inheritance taxes, yet maintain control over wealth. When families donate company stock to private family-run foundations, family control over the business can be assured from generation to generation, while inheritance taxes are avoided. The donor can control the management of the foundation -- appointing relatives, rewarding friends and employees. The foundation provides the conduit for donations which reduce the taxes on his business income.

Furthermore, this control can be parlayed to a point where the foundation is used to promote the foundation owner's other business interests. Practices have been uncovered which can be questioned on the basis of unfair competition, conflict of interest, self-dealing, "insider" arrangements to affect stock prices, and so forth.

Foundations, for example, can lend money to the founder, his family, or the family business at preferential interest rates, thus supplying venture capital for the donor's other interests. The Subcommittee's studies noted situations, where suppliers and buyers have made sizeable contributions to foundations, controlled by customers, indicating underhanded pricing deals. What's more, these organizations can enter into deals, whereby through intricate tax maneuvering, they can buy a business, invest none of their own money and pay the seller more than the market value of the business. On top of this, the deal can be set up as an installment purchase, permitting the seller to convert what should have been ordinary income into preferentially taxed capital gains.

A Prentice-Hall Executive Tax Report, for example, offers this advice:

> Have You Put a Price on Your Business? You may be able to double it -- by selling to a Charity.
>
> Say you're planning to sell your business, and you think a fair price would be five times earnings. If the company earns, say, $101,500 after taxes ($200,000 before), you're probably figuring on selling for about $500,000. If that's the case, STOP RIGHT THERE -- you may be shortchanging yourself:
>
> That business could be worth $1,000,000 to a tax-exempt organization: An ordinary buyer is only interested in earnings after taxes--that's all he gets to see. But a tax-exempt buyer keeps a hundred cents on the dollar. So a fair price to a charity would be five times $200,000, or $1,000,000--twice what you figured!

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Finally, the Report notes some "Frosting on the cake" and cites a case where the seller maintained 48% ownership of the corporation, "was active in management and drew a good salary."

Commenting on the abuses uncovered, a New York Times editorial added another dimension -- that of the increased role of foundations in shaping national policy:

> Since almost everyone pays income taxes, the burden of exempting the income of the foundations is borne by the public at large. Yet the public is virtually powerless to influence the ways in which the foundations spend their tax-free dollars.

Generous tax treatment is appropriate for charitable organizations since private philanthropy is an important adjunct to public programs serving the goals of the nation. However, this special treatment is justifiable only if these organizations are in fact using the foundations, and their tax-exempt privilege, for the public good and not merely for the private advantage of a select well-heeled few.

The House-passed bill would substantially narrow the permissible activities of private foundations desiring to preserve their tax-exempt status. Limits would be placed on self-dealing between foundations and contributors, and provisions are recommended which would require distribution of their income over a period of time, limit their private business holdings, and make sure that investments of these organizations are not jeopardized by financial speculation. The House would also levy a 7.5% tax on the investment income of private foundations.

The Administration has, in the main, endorsed the House action. However, the Administration recommends a 2% levy on investment income rather than the 7½% rate recommended by the House.

The AFL-CIO recommends that:

(1) Financial transactions between a foundation and its founders, contributors, officers, directors or trustees should be prohibited.

(2) Foundations should be required to spend their incomes within one year of receipt.

(3) Foundations should not be permitted to own 20% or more of any business unrelated to their charitable function -- a reasonable time should be allowed for presently organized foundations to comply with this provision.

(4) If a donor maintains control of a business or property after it is contributed, no donation deduction from taxes should be allowed until the foundation disposes of the property or the donor's control over the property ends.

(5) Foundation borrowing to buy investment properties should be prohibited. Foundation lending should be limited to appropriate charitable functions.

(6) A limitation, such as 40 years, should be placed on the life of foundations.

(7) Congress should carefully examine the problems posed by the actual operations of foundations and the need for some degree of federal regulation of the use of the tax-exempt funds of foundations.

Unlimited Charitable-Contribution Deduction

The ordinary taxpayer cannot deduct charitable contributions that exceed 30% of his income. However, through use of a little-known loophole -- the unlimited charitable-contribution deduction -- about 100 of the nation's wealthiest families escape paying $25 million in taxes. Many of these families pay no federal income taxes at all.

Though the loophole alone yields tax benefits to some of the nation's wealthiest, the major part of the tax bonanza comes about through combining the unlimited-deduction gimmick with another loophole -- that which permits the contribution deduction to be based on the appreciated value of assets (typically stocks) donated, not the cost. Hence, no tax -- not even at privileged capital-gain rates -- is ever paid on the appreciated value; yet the full amount is allowed as a deduction from income.

The unlimited-deduction privilege seems stringent in that it's only allowed if total contributions plus income taxes paid in eight out of the ten preceding years exceeds 90% of <u>taxable income</u>. However, these criteria are easily met by many wealthy individuals whose income comes from nontaxable sources. Thus many who rely upon state and local bond interest, or capital gains, or whose taxable income is "sheltered" by means of excessive depletion or depreciation deductions can easily give away large percentages of taxable income -- since so little of their income is subject to tax.

The Treasury studied the 1964 tax returns of four wealthy "non-taxpayers" and found that each had a total income of between six and ten million dollars and a taxable income of zero. Their incomes came almost entirely from dividends and/or capital gains. Each gave away property close to, or in excess of, the <u>reported</u> adjusted gross income -- property which was for the most part appreciated stocks, upon which no capital-gains tax was ever paid -- and in each case, taxable income and income tax were $0.

As a result, a seemingly innocent and appropriate tax-forgiveness provision geared to encouraging philanthropy serves in the main to divert public revenues to private use. The public revenue cost is far out of proportion to the philanthropic goals forwarded, and the difference flows to a privileged few individuals of extreme wealth.

What is more, studies have shown that the charities supported by the contributions of the wealthy are generally quite different from those that receive the bulk of their contributions from the majority of the nation's taxpayers. And this evidence suggests that Congressional intent and the national interest in supporting charitable organizations is thwarted.

For example, a 1965 Treasury Department report showed that in the income classes under $20,000, over 80% of the contributions went to religious organizations and charities concerned with social welfare, such as the Community Chest and the Red Cross. In contrast, those in the over-$1,000,000 income class gave over two-thirds of their contributions to so-called "other organizations" -- principally foundations. Religious and social-welfare organizations like the Community Chest received less than 10% of the wealthier group's philanthropy.

The House tax-reform bill would phase out the unlimited-charitable-contribution loophole over a five-year period. However, the House would also increase the general-charitable-contribution deduction from its current level of 20% or 30% (depending on type of organizations contributed to) to 50%. In the main, the Administration has endorsed these proposals.

The AFL-CIO recommends immediate repeal of the unlimited-charitable-contribution deduction. The approximate revenue gain under our proposal would be $50 million. Under the House and Administration proposals $20 million would be gained.

The 7% Investment Credit

The investment-credit tax privilege was added to the Internal Revenue Code in 1962 and liberalized in 1964. The privilege was enacted as an effort to spur the economy by encouraging business to invest in new machinery and equipment.

Under this provision, business firms are permitted to deduct from the federal income taxes owed an amount equal to 7% of the cost of new machinery and equipment. The full 7% can be deducted for firms with tax liabilities up to $25,000. If the tax liabilities are more than $25,000 the amount of credit that can be deducted is limited to one-fourth of their taxable income. In other words, the only limit on the credit is that it cannot reduce the firm's tax bill by more than 25%.

In effect then, the nation's taxpayers are picking up the tab so that a private firm can get a discount on the costs of its equipment.

What's more, prior to 1964, businesses had to deduct the credit from the cost of the investment before they were allowed to write off depreciation. This was changed in 1964 and currently the credit can be taken, and the full purchase price can be written off. Thus, more than 100% of the cost can be written off and, like the oil-depletion deduction, imaginary expenses are used to reduce taxable income.

The revenue cost of the credit, according to the Treasury, amounts to $3.3 billion at current levels of business profits and investment. This $3.3 billion tax forgiveness subsidy induces increased business investment and feeds the only major source of inflationary-demand pressure in 1969 -- while the entire national economy is burdened with tight money, unprecedented interest rates and other generally restrictive measures.

Both the House and the Administration recommend repeal of the credit. This is also the position of the AFL-CIO.

The approximate revenue gain would be $3.3 billion.

Multiple Surtax Exemptions

The corporate income tax is a two-step affair. The first $25,000 of profit is taxed at a rate of 22% and the remainder is taxed at 48% (excluding the temporary 10% surtax).

The exemption of the first $25,000 from the full corporate tax rate was made part of the Internal Revenue Code in order to help small corporations.

However, the intent of this provision has been thwarted by many large corporations, which have intentionally organized themselves into chains, to shelter much of their income from the full corporate rate.

Thus, by spinning off into subsidiaries, a corporation can reduce its taxes annually by $6,500 per subsidiary. A single corporation, for example, with a net profit of $1 million would pay a tax of $473,500. If the same corporation operated through 40 subsidiaries, each showing a profit of $25,000, the tax would be cut by more than half.

The Treasury estimates that the exemption results in a reduction of the tax rate on corporations generally from 48% to 45.8% and a revenue loss of approximately $1.8 billion. The combined effect of both the 7% investment credit and the $25,000 exemption brings the effective rate down to only 43.4% and the revenue loss to some $4-5 billion.

Moreover, this special privilege amounts to a tax incentive that encourages unsound corporate arrangements. It also adds an element of discrimination between those types of corporations that can easily be split up to take advantage of the special privilege and those that cannot.

As a result, a benefit intended to help small business also provides tax-windfall opportunities to large, highly profitable operations.

Both the House and the Administration recommend repeal of the multiple surtax exemption. This is also the position of the AFL-CIO.

Approximate revenue gain: $235 million.

Conglomerates

The greatest wave of corporate mergers in American history is now rolling through the economy. This great movement towards the concentration of economic power has been building up over the last 20 years. It obscures the peaks of the two previous corporate merger waves in 1899 and 1929. The number of mergers of mining and manufacturing companies zoomed from 219 in 1950 to 844 in 1960 to nearly 1,000 in 1966 and over 2,400 in 1968, according to the Federal Trade Commission.

Not only are the "bigs" taking over the "smalls", but minnows are swallowing whales, and the "bigs" are merging with other "bigs." Conglomerates marriages, with increasing frequency, involve partners with assets over $10 million. In 1966, there were 101 mergers involving an acquired company with assets in excess of $10 million. The Federal Trade Commission reported 192 such mergers in 1968, with assets of the acquired companies totaling $12.6 billion. The 200 largest companies acquired 70 firms in mergers in 1968, the FTC reported.

As a result, one out of every six firms that made Fortune Magazine's 1962 top-500 list has completely disappeared.

These conglomerate corporations grow in all directions, by acquiring companies in any industry or product-line, no matter how unrelated. They operate in all kinds of different industries and markets.

The great merger movement of recent years has brought an alarming increase in the concentration of economic power in the hands of the major corporations. In 1967, the 200 largest manufacturing corporations held nearly 59% of the total assets of all manufacturing corporations -- up

from about 48% in 1948. The 78 giant manufacturing corporations, with assets of $1 billion or more, held 43% of the assets of manufacturing corporations in 1968 and received 49% of the profits of all manufacturing corporations.

The concern is not with large conglomerate corporations merely because they are large. It is the effects which must be examined. The immediate questions concern plant closedowns and impacts on collective bargaining and the local community. Beyond this, what does the concentration of economic power do to the political system and economic system, in terms of prices, competition, efficiency and inventiveness?

These questions go beyond those that can be answered through the tax structure. They involve the anti-trust laws and the operations of the Justice Department, as well as such other government agencies as the Federal Trade Commission and the Securities and Exchange Commission. Yet it is clear that there are tax inducements to those who would merge and the tax structure adds thrust to the corporate take-over movement.

* By "swapping debt for equity" (offering bonds in exchange for stock) the acquiring firm has to pay bond interest rather than stock dividends. Interest is tax-deductible; dividends are not. Because of this tax advantage, the purchaser can offer a bond (debenture) supposedly valued at more than the stock, creating what has been labeled "funny money."

The seller also has a tax advantage since he pays no taxes on the transaction until the bond is paid off. Hence, it is the nation's taxpayers who are helping to finance the take-over.

* If the seller receives stock in the acquiring firm in exchange for his old stock, the transaction, under most circumstances, is tax-free. Of the 352 major acquisitions that took place in 1967 and 1968, some 90% were tax-free. The "new" firms were valued in the stock market at $3 billion higher than the pre-merged firms; yet no taxes were paid.

* The tax-loss "carry-over" provisions in the Internal Revenue Code lead to anomalous situations, where a firm showing a loss becomes a more desirable partner for a merger than a profitable one. And again the nation's taxpayers are the losers. If a firm has losses, it pays no taxes. If the firm merges with a profitable firm, its losses can be washed out against the acquiring firm's otherwise taxable income. And, of course, other tax loopholes can be called into play to create phantom losses and situations similar to the tax havens built by wealthy real-estate speculators and tax-loss farmers.

Moreover, other business tax privileges -- as the 7% investment credit, for example, and accelerated depreciation -- help to provide many corporations with unreasonably large amounts of cash (depreciation allowances plus retained profits) after payment of taxes and dividends to stockholders. The cash is thus available for such ventures as those involved in the sharp rise of foreign investment and buying out other firms.

The House bill would curtail some of the financial manipulations that encourage the rise of corporate mergers and the spread of conglomerates. The AFL-CIO agrees with these proposals. Most important, under the House action (supported by the Administration), limitations would be placed on the amount of interest deductions allowed on debt used to finance corporate mergers and acquisitions.

The AFL-CIO recommends that such interest deductions be completely disallowed. Furthermore, the AFL-CIO recommends a thorough investigation

be conducted to determine the extent to which the federal tax structure contributes to the alarming trend of corporate mergers and acquisitions.

Among the tax provisions that should be examined are those which permit:

1. Capital-gains taxes to be paid in installments when stock is exchanged for debt securities.

2. Tax-free exchanges on corporate stock transfers made for purposes of mergers and acquisitions.

3. Corporations to "carry over" the operating and capital losses of an acquired firm.

In addition, the penalty tax provisions applying to excessive amounts of retained profits should be made workable in the light of recent experience.

Other House Proposals

The House bill includes other improvements which we consider steps toward tax justice and which we support. Among these are:

1. Liberalization of moving expense deductions.
2. Tightening of the deferred-compensation loophole.
3. Limiting the tax advantages of foreign investment income.
4. Requiring financial institutions to shoulder more of the tax burden.
5. Eliminating special tax breaks for stock dividends.

Table 1

FEDERAL INCOME TAX BURDEN

Present Law Compared With House Reform Bill, Treasury Proposals, and AFL-CIO Proposals
Married Couple, 2 Dependents

Wage or Salary Income	Total Tax				Tax Reduction		
	Present Law	House Reform Bill	Treasury Proposals	AFL-CIO Proposals	House	Treasury	AFL-CIO
$3,000	0	0	0	0	-	-	-
4,000	$140	$65	$81	$45	$75	$59	$95
5,000	290	200	253	155	90	37	135
7,500	687	576	616	526	111	71	161
10,000	1,114	958	1,012	908	156	102	206
12,500	1,567	1,347	1,447	1,300	220	120	267
15,000	2,062	1,846	1,951	1,822	216	111	240
20,000	3,160	2,968	2,968	3,030	192	192	130
25,000	4,412	4,170	4,170	4,282	242	242	130
50,000	13,388	12,604	12,604	13,258	784	784	130
100,000	37,748	34,892	34,892	37,618	2,856	2,856	130

Assumes deductions equal to 10% of income, minimum standard deduction (low income allowance) or standard deduction — whichever is greater. Table takes into account the rate cutting, standard-deduction changes, and low-income allowance proposed by the House, the Treasury and the AFL-CIO. Surtax excluded.

Table 2

EFFECT OF AFL-CIO PROPOSED REDUCTION IN FIRST 5 TAX BRACKET RATES TO 9%, 13%, 15%, 16%, AND 18% ON MARRIED TAXPAYER FILING JOINT RETURN

Taxable Income 1/	Present Federal Income Tax	Tax Under AFL-CIO Proposal	Tax Reduction	Tax Reduction as a Percentage of Present Tax
$ 1,000	$ 140	$ 90	$ 50	35.7%
2,000	290	220	70	24.1
3,000	450	370	80	17.8
5,000	810	710	100	12.3
7,500	1,285	1,160	125	9.7
10,000	1,820	1,690	130	7.1
12,500	2,385	2,255	130	5.5
15,000	3,010	2,880	130	4.3
20,000	4,380	4,250	130	3.0
35,000	9,920	9,790	130	1.3
50,000	17,060	16,930	130	.8

1/ Wage and salary income less personal exemptions and deductions.

Note: Figures exclude 1968 surtax and do not take into account additional relief measures which would increase the standard deduction and provide a low-income allowance.

Table 3

IMPACT OF FEDERAL, STATE & LOCAL TAXES
FAMILY OF FOUR:
1963 to 1968

Wage or Salary Income	Decrease in Federal Income Tax	Increase In OASDHI	Increase in State & Local Taxes	Change in Net Income After Taxes		
				Federal Income Taxes Only	Federal Income & OASDHI	Federal Income, OASDHI, S & L
$1,000	-	$7.75	$89.00	-	- 0.9%	- 14.2%
2,000	-	15.50	110.00	-	- 0.8	- 7.9
3,000	$60.00	23.25	132.00	+ 2.0%	+ 1.3	- 3.9
5,000	130.00	46.00	168.00	+ 2.8	+ 1.9	- 2.2
7,500	139.50	156.00	182.00	+ 2.1	- 0.3	- 3.4
10,000	174.45	169.20	245.00	+ 2.0	0	- 3.1
12,500	216.50	169.20	290.00	+ 2.0	+ 0.5	- 2.6
15,000	270.35	169.20	317.00	+ 2.1	- 0.8	- 1.9
20,000	403.00	169.20	368.00	+ 2.5	+ 1.5	- 0.9
35,000	943.40	169.20	567.00	+ 3.6	+ 3.0	+ 0.9

State and local taxes were estimated by the AFL-CIO Research Department. These estimates were based upon Council of Economic Advisers studies for 1965 and Bureau of Census state and local tax data for 1963, 1965 and 1968.

Federal income taxes based on family of four, using the minimum standard deduction where applicable and assuming deductions equal to 10% of income for all other groups.

Table 4

RETURNS WITH TAXABLE INCOME, 1966
EFFECTIVE TAX RATES

Adjusted Gross Income (thousands)	Effective Tax Rate on Present-Law Taxable Income	Effective Tax Ra[illegible] On Taxable Income Including Excluded Half Of Capital Gains*
0 to $5	15.3%	15.0%
5 to 10	16.4	16.2
10 to 20	18.1	17.8
20 to 50	24.0	22.8
50 to 100	35.8	32.6
100 to 200	45.6	37.8
200 to 500	52.3	37.9
500 to 1,000	55.3	35.8
1,000 and over	55.5	32.7

* These effective rates are actually overstated -- particularly in the upper brackets -- because other forms of exempt income, such as interest from state and local bonds, are not taken into account in this table. For example, the Treasury Department estimates that the effective tax rate on total income for nearly two-thirds of those with adjusted gross incomes of one million dollars and over is 30% or less -- 4% of this group pay an effective tax rate of 5% or less.

Source: U.S. Treasury Department "Tax Reform Studies and Proposals", February 5, 1969, p. 81.

Table 5

SELECTED DATA FROM INCOME-TAX RETURNS
REPORTING FARM PROFITS AND LOSSES

Adjusted Gross Income	Farm Returns			
	Net Profit		Net Loss	
	Number of Returns	$ Amount (000's)	Number of Returns	$ Amount (000's)
Under $5,000	415,346	$728,615	180,557	$183,588
5-10,000	502,044	1,580,178	371,917	410,518
10-20,000	240,493	1,386,520	161,340	254,104
20-50,000	50,608	605,232	41,441	161,673
50-100,000	6,059	100,476	10,023	83,326
100,000-1,000,000	1,292	25,537	4,262	85,827
1,000,000 or more	12	74	101	7,577

Source: U.S. Treasury Department, Internal Revenue Service, Preliminary Statistics of Income, Individual Income Tax Returns, 1967

Table 6

ILLUSTRATION OF AFL-CIO 25% TAX ON EXEMPT INCOME AND ALLOCATION OF DEDUCTIONS PROPOSALS ON A TAXPAYER (ACTUAL CASE) WITH OVER $1 MILLION OF INCOME AND AN EFFECTIVE TAX RATE OF .03%

Actual Case Cited by Treasury Department

A. Application of Allocation of Deductions Proposal

	Actual	Proposed
Reported adjusted gross income	$679,405	$679,405
Less: personal exemption	-600	-600
Less: itemized deductions	-676,419	-357,352*
TAXABLE INCOME	2,386	321,453
Income Tax	$383	$210,507

* Computed as follows:

Adjusted gross income	$679,405
Add: excluded capital gains	605,313
Add: excess depreciation on real estate 1/	11,141
Total Income	$1,295,859

$$\text{Deductions} \times \frac{\$679{,}405}{\$1{,}295{,}859 - \$10{,}000} = \$357{,}352 \text{ allowable deductions}$$

B. Application of 25% Tax on Exempt Income

	Actual	Proposed
Total excluded income:		
Excluded capital gains		$605,313
Excess depreciation on real estate		11,141
		616,454
Less: $10,000		-10,000
Less: disallowed deductions ($676,419 - $357,352)		-319,067
Exempt income subject to 25% tax		287,387
25% tax on exempt income		$71,847
Add: tax on taxable income after deductions allocated		210,507
Income Tax	$383	$282,354
Income Tax as % of Total Income	.03%	21.8%

1/ Actual loss reported was $22,283 -- analysis assumes only one-half of this loss due to excessive depreciation.

NOTE: 1968 surtax excluded.

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Table 7

ESTIMATED FEDERAL REVENUE GAINS RESULTING FROM MAJOR AFL-CIO LOOPHOLE CLOSING PROPOSALS

Loophole-Closing Proposals		Approximate Revenue Gain Millions of Dollars
1. Elimination of Preferential Tax Treatment of Capital Gains		$6,000 - 7,000
2. Taxation of Gains on Property Transferred at Death		3,100[1/] 4,200[2/]
3. Disallowance of Depletion after Investment Fully Written Off		1,500
4. Elimination of Tax-Exempt State and Local Bond Interest and Inclusion of Federal Subsidy and Loan Guarantee		100
5. Elimination of 7% Investment Credit		3,300
6. Elimination of Accelerated Depreciation on Real Estate Except for Low- and Moderate-Income Housing		1,500
7. Limitation of Farm-Loss Deductions		145
8. Elimination of Unlimited Charitable-Contribution Deduction		50
9. Elimination of Corporate Multiple Surtax Exemption		235
Total		$15,930 - 18,030
10. Allocation of Deductions[3/]	$ 250	
11. 25% Minimum Tax on Exempt Income[3/]	1,500	
Total	$1,750	

1/ If taxed at current capital-gains rates.
2/ If taxed at full rates.
3/ Proposal would not apply if loopholes eliminated.

SUMMARY

of

TESTIMONY BY SEN. LEE METCALF (D-Mont.) ON BEHALF OF HIS PROPOSAL TO ELIMINATE "TAX-DODGE" FARMING -- Before the Senate Finance Committee 22 September 1969

My bill, S. 500, would eliminate existing distortions in the farm economy by limiting to $15,000 or to the amount of "special deductions" listed in my bill, whichever is higher, the amount by which a "farm loss" may offset nonfarm income. Special deductions are those that would be allowed to someone whether or not he was in farming or because it is the type of deduction clearly beyond a taxpayer's control. I am referring to such things as taxes, interest, abandonment or theft of farm property, fire, storm, or other casualty, losses and expenses from drought, and recognized losses from sales, exchanges and involuntary conversions of farm property. Neither the House-passed bill nor the Administration's proposal contain a comparable provision to protect the legitimate farmer and rancher from being penalized for having incurred an economic agricultural farm loss in a given year. My bill also provides safeguards to protect those just starting out in farming as well as those who might find themselves in a loss situation in a given year, not by design for tax purposes but rather by chance. This is accomplished by a provision that allows any disallowed loss to be carried back three years and forward five years against past or future farm income.

The problem with the approach recommended by the Administration and now contained in the House-passed bill except for different dollar exclusions is that it allows the tax-dodge farmer to defer any recognized capital gains while at the same time he is allowed to continue using the full amount of his artificial losses as an offset against nonfarm income year after year. By attempting to convert capital gains into ordinary income rather than nip the losses in the bud before the tax-dodge farmer can use them, both the House bill and the Administration allow offenders an easy out with just the proper amount of tax planning.

Revenue figures provide some insight into the comparative effectiveness of the House bill, the Administration's proposal, and S. 500. My bill would affect about 14,000 individual tax returns and would raise an additional $205 million a year from these individuals. The House bill would affect about 3,000 returns and when fully operative raise an additional $25 million annually. These revenue estimates do not include comparative figures for corporations. I can only imagine the amount by which the gap between the two bills would widen even further.

The Administration estimated its 4 September proposal would apply to 9,300 individuals and raise $50 million annually. The Administration has already admitted that although the House bill adopts the same approach, the dollar exclusions contained in the House bill are so high as to render it ineffective.

Here is a unique opportunity to combine substantial revenue increases with substantial equity by restoring healthy competition to our farm economy. The House-passed bill can be reshaped to serve as a meaningful vehicle for equitable and effective reform in this area.

# # # #

TESTIMONY BY SEN. LEE METCALF (D-Mont.) ON BEHALF OF HIS PROPOSAL TO ELIMINATE "TAX-DODGE" FARMING -- Before the Senate Finance Committee

22 September 1969

I appreciate the opportunity to testify for legislation that would remove inequities between legitimate farm operators and tax-dodge farmers -- people who engage in farming for the purpose of creating artificial losses which can be used to offset substantial amounts of their nonfarm income.

In the first session of the 90th Congress, I introduced S. 2613, to amend the Internal Revenue Code of 1954 to provide that farming losses incurred by persons who are not bona fide farmers may not be used to offset nonfarm income. When I ultimately decided upon the loss limitation approach as the best way to get at this problem, one of the sources of information I considered was an article written by Hendrik S. Houthakker, now a member of the Council of Economic Advisors. At the time that he wrote the article, Mr. Houthakker was engaged as a professor of Economics at Harvard. He concluded his article, which appeared in the January-February 1967 issue of Challenge, with the observation that "if this sacred cow is to be finally eliminated, the Internal Revenue Service may need some help from the Congress."

I found Mr. Houthakker's discussion of possible methods to get at this problem particularly stimulating. He stated as follows:

> "If the tax laws are to be effective in this area, a more sophisticated definition of farmers is needed, or, alternatively, the offsetting of farm losses against other income should be restricted. But this restriction has to be introduced with due regard to the interests of genuine farmers.
>
> "The best possibility would be to limit the farm loss deduction to, say, $10,000 in any one year, with provisions to carry larger losses backward or forward to be offset against earlier or later farm profits, but not against nonfarm income. In 1962 the taxpayers who claimed over $10,000 in farm losses had an average nonfarm income of about $50,000.
>
> "Another possibility would be to treat as farmers only those who have derived a specified fraction of their income from farming during the past five years.
>
> "Still another (similar to the Treasury proposal of 1963 which was rejected by Congress) would be to allow capital gains treatment only for the amount by which sales exceed deductions for farm losses in prior years. This proposal, however, would not deter those who do not take capital gains at all."

The 1963 Treasury proposal referred to by Mr. Houthakker is basically the same proposal as that suggested by Administration officials in their testimony before the House Ways and Means Committee on 22 April of this year and restated again but with higher dollar figures before this Committee on 4 September. This proposal which has come to be known as the Excess Deductions Account approach is now contained in the tax reform bill under review by this Committee.

In July of last year, both the Departments of Treasury and Agriculture issued highly favorable reports on S. 2613, the predecessor to my bill, S. 500, which I reintroduced with substantial bipartisan support in January of this year. Both of those reports endorsed the principle of my original bill but at the same time suggested constructive modifications which I incorporated in the bill which was introduced last Fall for discussion purposes and then reintroduced early this session.

In order for the record to be complete on this matter here are the constructive suggestions made by the Treasury Department in its report of 11 July 1968:

"As an alternative, we suggest placing a ceiling on the amount of nonfarm income which could be offset by farm losses in any one year. If there were excess farm losses, they could be carried backward and forward to offset farm income, but no other income, of other years. If part of a taxpayer's income for a year consists of capital gains, his carryover of excess farm deductions arising from the special farm accounting rules would not be permitted to offset it. On the other hand, the ordinary farmer incurring a loss would be protected under this approach in two ways: First, by allowing a limited deduction for farm losses, an ordinary farmer who must take part-time or seasonal employment to supplement his income in a poor year in his farm operations would not be deprived of his farm loss deductions. Second, the carryover and carryback provisions would be available to absorb large one-time losses. In other words, the provision would, in operation, only affect taxpayers with relatively large amounts of nonfarm income, that is, individuals who do not have to depend on their farm income for their livelihood.

"It is suggested that ... corporations could be covered in the same manner as individual farmers and farms run by a partnership."

The Treasury Department concluded by suggesting that some kinds of farm expenses should be excepted from the disallowance provisions. Here is the reason for that suggestion:

"One category of farm expenses would include taxes and interest which are generally deductible whether or not they are attributable to an income producing activity. A second category would include casualty and abandonment losses and expenses and losses arising from drought. These events are generally not in the taxpayer's control and disallowance of the loss or expense could create an undue hardship to the taxpayer since they may be catastrophic. These same ex-

penses and losses are now excluded from the operation of section 270 which excludes losses in connection with a hobby operation."

One additional suggestion made in the report was to provide "for an adjustment that would limit the measure of allowable farm deductions to the taxable one-half of capital gains." The reason for this suggestion was to prevent the taxpayer from receiving a double deduction against his capital gain farm income.

The suggestions contained in last year's Treasury and Agriculture reports together with those contained in Mr. Houthakker's article made a great deal of sense. For example, it was clear that all concerned agreed the most equitable and effective way to get at this problem is to limit the amount of farm losses that can be used as an offset against nonfarm income in any one year.

The problem which now exists is that liberal tax accounting rules designed for the benefit of the ordinary farmer are being manipulated by nonfarmers. These nonfarmers engage in farming for the purpose of creating artificial losses that they can use to reduce the taxes they would otherwise have to pay on high-bracket nonfarm income. The tax losses which these tax-dodge farmers show are not true economic losses. These so-called "tax losses" arise from deductions taken because of capital costs or inventory costs and thus usually represent an investment in farm assets rather than amounts actually lost. Usually, the investment is ultimately sold and taxed only at lower capital gains rates.

The deductions are set off against ordinary income, while the sale price of the resulting assets represents capital gain. The gain is then usually the entire sales price since the full cost of creating the asset has previously been deducted against ordinary income. In reporting on my original bill, S. 2613, in July of 1968, the Treasury reviewed the two principal methods of accounting used in reporting business income for tax purposes. Generally speaking, those businesses which do not involve the production or sale of merchandise may use the cash method. Under that method, income is reported when received in cash or its equivalent, and expenses are deducted when paid in cash or its equivalent.

However, in businesses where the production or sale of merchandise is a significant factor, income can be properly reflected only by deducting the costs of merchandise in the accounting period in which the income from its sale is realized. This means that costs are recorded when incurred and sales when made, and costs attributable to unsold goods on hand at year's end are included in inventory. Under this method of accounting, the deduction of costs included in inventory must be deferred until the goods to which they relate are sold rather than being deducted when the costs are incurred. Thus, under this second method of accounting, income from sales of inventory and the costs of producing or purchasing such inventory are matched in the same accounting period. The end result in this type of business is a proper reflection of income.

The Treasury Department has historically permitted farmers to deviate from general accounting practices to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting. In addition the Treasury has in the case of some capital outlays permitted farmers to write them off as if they were current expenses.

On 5 February of this year, the House Ways and Means Committee published a study of needed areas for tax reform conducted by the Treasury Department during the last two years of the Johnson Administration. In discussing the effect that tax-dodge farmers have on the farm economy the study points out that "when a taxpayer purchases and operates a farm for its tax benefits, the transaction leads to a distortion of the farm economy. The tax benefits allow an individual to operate a farm at an economic breakeven or even a loss and still realize an overall profit. For example, for a top-bracket taxpayer, where a deduction is associated with eventual capital gains income, each dollar of deduction means an immediate tax savings of seventy cents" -- or seventy-seven cents with the surtax -- "to be offset in the future by only twenty-five cents of tax. This cannot help but result in a distortion of the farm economy, and is harmful to the ordinary farmer who depends on his farm to produce the income needed to support him and his family.

"This distortion may be evidenced in a variety of ways: For one, the attractive tax benefits available to wealthy persons have caused them to bid up the price of farmland beyond the price which would prevail in a normal farm economy, and is harmful to the ordinary farmer who must compete in the marketplace with these wealthy farm owners who may consider a farm profit -- in the economic sense -- unnecessary for their purposes."

My bill would eliminate these distortions by limiting to $15,000 or to the amount of the "special deductions" listed in the bill, whichever is higher, the amount by which a "farm loss" may offset a taxpayer's nonfarm income. The $15,00 figure is reinforced by the following observation contained in Treasury's two-year study, and I quote: "If a taxpayer has more than $15,000 of nonfarm income, his primary source of livelihood is not likely to be his farming efforts, and, thus, he is not the type of farmer for whom the special accounting rules were devised." Generally, a farm loss would be the amount by which farm deductions exceeded farm income in any given year. For this purpose, as the 1968 Treasury report suggested, the untaxed one-half of long-term capital gains attributable to farm property would not be included in farm income. Farm deductions include all deductions that are attributable to the business of farming. If the taxpayer's nonfarm income is in excess of $15,000 in any given year, the limit on his deductible loss in that year would be reduced by one dollar for each dollar of such excess. However, economic losses are protected by providing that the $15,000 loss limitation will be raised to the amount of the taxpayer's special deductions if that amount is higher than $15,000.

When Assistant Secretary of the Treasury Edwin S. Cohen testified before this Committee on 5 September he referred to the fact my bill

is now pending before this Committee. He was then asked by Senator Hartke and I quote: "What is wrong with that bill?" Answer by Mr. Cohen. "Well, suppose as Senator Gore said, a short while ago, there were an actual economic loss of $50,000, suppose there is an actual economic loss from tornado, floods, low prices, drought, any number of factors, why should we disallow a true economic loss to the farmer or where should we disallow it in any event at strictly $15,000 a year."

There are two observations I must make with respect to that answer. First, if there were an actual economic loss of $50,000 from tornado, floods, low prices, drought or any other factor beyond the control of the taxpayer under the provisions of my bill the entire amount of that economic loss could be used to offset nonfarm income. Assistant Secretary Cohen's answer simply demonstrated that he had never read my bill. My bill specifically takes into account the nature of the deductions that generate a loss in a given year. It provides that if the sum total of deductions paid or incurred in the business of farming and which are attributable to taxes, interest, the abandonment or theft of farm property, or losses of farm property arising from fire, storm, or other casualty, losses and expenses directly attributable to drought, and recognized losses from sales, exchanges and involuntary conversions of farm property -- if any one or all of those deductions adds up to a figure that is higher than $15,000 then the taxpayer is allowed to use the higher figure as an offset against nonfarm income. An exception is made in my bill for such deductions since they are in general deductions which would be allowed to anyone holding farm property without regard to whether it was being used in farming or because it is the type of deduction that is clearly beyond the control of the taxpayer.

My second observation is that assuming an actual economic loss of $50,000 caused by any of the economic factors listed by Assistant Secretary Cohen, and assume one additional fact . . . that the taxpayer has an adjusted gross nonfarm income in excess of $25,000 in that same year, it is the Administration's proposal that would penalize the taxpayer for an economic loss. Although the loss could be used as an offset against nonfarm income the entire amount of that loss would have to be included in the Administration's excess deductions account. To the extent of the balance in that account, what would otherwise be a long-term capital gain from farming in a subsequent year would be converted into ordinary income. The House-passed bill would also attempt to recapture an economic loss by the same method but to a lesser degree because it only applies to that portion of a farm loss above $25,000 and then only if nonfarm adjusted gross income is above $50,000. When Assistant Secretary Cohen testified he observed that the dollar exclusions contained in the House-passed bill render the bill ineffective.

Getting back to the loss limitation approach, my bill adopts a suggestion made in both the 1968 Agriculture and Treasury reports as well as in Mr. Houthakker's article. If the farm loss in any given year is greater than the allowable amount, it would be carried backward three years and forward five years to offset farm income of those years. This safeguard is in the bill to protect new farmers who are sincerely

interested in farming but who understandably might be unable to turn an economic profit in those years.

My bill also provides that a taxpayer may treat a nonfarm business as a part of his farming operation if it is related to and on an integrated basis with the farm business. Some recent inquiries about this provision indicate that there are those who would attempt to use it to offset some artificial farm losses arising from the farm tax accounting rules against income earned in another business. This provision is not intended to allow a business to be considered as related and conducted on an integrated basis with the farming operation unless it consists of the processing of a product raised in the farming operation. Furthermore, it is only equitable that to qualify to elect this provision, the sale of such processed product should produce a substantial portion of the total receipts of the over-all operation. Moreover, this provision is intended only for purposes of measuring the size of the "farm loss" to ascertain whether certain deductions are allowable. This provision is not meant to allow the nonfarm business to be treated as a farm operation for the purpose of adopting accounting methods, the filing of estimated tax returns, or the filing of final returns, and the like.

The House-passed bill and the Administration's proposal both adopt the proposal contained in S. 500 which would exclude from the application of any limitation, the taxpayer who is willing to follow with respect to his farming income, accounting rules which apply generally to other taxpayers; that is if he uses inventories in determining taxable income and treats as capital items -- but subject to depreciation in cases where other taxpayers would take depreciation -- all expenditures which are properly treated as capital items rather than treating them as expenses fully deductible in the current year.

My bill has gained substantial bipartisan support in both the House and the Senate. Twenty-six other Senators, including three members of this Committee (Senators Hartke, McCarthy and Harris) are cosponsors of S. 500. At last count, the loss limitation approach contained in the bill had been specifically endorsed by members of at least thirty different Congressional delegations.

Aside from Congressional support the method of approach taken in S. 500 has the full support of all those who are sincerely interested in the working farmers of our Nation. For example, the National Farmers Union, the American Farm Bureau Federation, the National Grange, the National Farmers Organization, the National Council of Farmer Cooperatives, the National Association of Wheat Growers, the Cooperative League of the U.S.A., the National Association of Farmer Elected Committeemen, the Farmland Industries Cooperative, the Mid-Continent Farmers Association -- formerly known as the Missouri Farmers Association, the Farmers Grain Dealers Association, the AFL-CIO, the Industrial Union Department of the AFL-CIO, the United Steelworkers, the South Texas Cotton and Grain Association, Inc., and the Amalgamated Meat Cutters and Butcher Workmen, have all called for a limit to be placed on the amount of artificial farm losses that can be used as an offset against nonfarm income.

Contrast this type of support with the testimony of the National Livestock Tax Committee before the House Ways and Means Committee some six years ago. This is what the National Livestock Tax Committee had to say about the excess deductions account approach in 1963 and I quote: "We cannot say whether it would work or would not, but it is the most modest approach that has come to our attention."

Well, that sort of grudging praise coming from an organization that has been fighting tax reform in this area every step of the way made me take a hard look at the EDA approach when I first considered ways to get at this problem without hurting the legitimate farmer.

The basic problem with the EDA approach is that it allows the tax-dodge farmer to defer any recognized capital gains until he chooses to sell and at the same time, allows him to continue along his merry way each year using artificial farm losses as an offset against non-farm income. With proper tax planning the balance in the excess deductions account can be milked dry by the time the taxpayer decides he is ready to recognize long-term capital gains. Such a proposal will not remove any of the incentive from existing clients of cattle management firms such as Oppenheimer Industries. Instead of catching the tax-dodge farmer with his hand in the cookie jar by limiting premature deductions each year, the EDA approach lets the tax-dodge farmer put us in the position of having to refill an empty jar.

Farm operations carried on by corporations usually are not separately reported on the corporation tax return. Consequently, data concerning the number of corporations and revenue effect with respect to corporations could not be determined with respect to either the EDA approach or the loss limitation approach.

However, I do have revenue figures that provide some insight into the comparative effectiveness of the House bill, the Administration's proposal, and S. 500. At my request the Chief of Staff of the Joint Committee on Internal Revenue Taxation, Laurence N. Woodworth, has provided me with the following statistics.

My bill would affect in the neighborhood of 14,000 individual tax returns. It is estimated that it would raise an additional $205 million a year from these individuals. The number of returns affected by the "Excess Deductions Account" provision of H.R. 13270 is estimated to be in the neighborhood of 3,000. By 1979 the estimated increase in tax liability under the farm provisions of the House bill are as follows: excess deductions account, $10 million; depreciation recapture, $5 million; holding period of livestock, $5 million; hobby losses, negligible; for a total of $20 million by 1979. It is estimated that sometime after 1979 the increase in tax liability ascribed to the excess deductions account provision would increase an additional $5 million. So we are talking in terms of increased revenue under the House-passed bill of $25 million a year as opposed to $205 million under S. 500. These revenue estimates do not include comparative figures for corporations. We can only leave to the imagination the amount by which the gap between the two bills would widen even further.

The Administration estimated on 4 September that its modified EDA rule "would apply to only 9,300 individuals" and that the long-range revenue effect of its farm loss provisions would be $50 million, still a far cry from the amount of revenue that could be raised by equitably and effectively dealing with this problem.

Elimination of the exception for livestock from the depreciation recapture rules was analyzed in detail several years ago by the President of Oppenheimer Industries, General Harold L. Oppenheimer. General Oppenheimer has been described by Time magazine as the "Bonaparte of Beef". He has authored three books for the cattle industry, Cowboy Arithmetic, Cowboy Economics and Cowboy Litigation. I have been informed by his Washington representative that a fourth book, Cowboy Politics is now in preparation. Here is what the General had to say in 1966 in his book, Cowboy Economics, about the depreciation recapture provision that has since been adopted in the House-passed bill:

"Members of Congress and officials of both the old and the new administrations have suggested that where accelerated depreciation is taken, on any subsequent sale, the portion of the capital gain which represents the recovery of previously taken depreciation should be treated as ordinary income. This is essentially the system now used in Canada.

"Evaluation. This piece of legislation is undoubtedly going to get passed within the next year or so, although it was deleted by the House Ways and Means Committee from the 1964 Tax Bill. However, as far as breeding herds are concerned, this is a matter of relatively little significance. During the first two years of a purchased breeding herd, the culls sold from the herd on a capital gain basis are very unlikely to exceed the depreciated value by more than a few dollars. During the third and fourth years, this could be a matter of some importance in the sale of culls but without an appreciable percentage effect on the overall picture. During the fifth year, most of the animals with an original capital base will have been sold and the herd will consist almost entirely of animals born to it at no cost basis, so the effect this legislation would achieve would then be zero."

General Oppenheimer's book, Cowboy Litigation, contains an interesting chapter , "Tax Play in Race Horses." Here are some of the observations contained in that chapter.

"The tax aspects of the horse business are unique, but in most instances, parallel the cattle business . . .

"Stud fees paid by the owner of a mare are currently deductible or they can be capitalized and depreciated over the life of the foal. Unless the breeder is in a loss position and concerned about a so-called hobby loss, it would be better to expense the fee. . .

"Depreciation can produce considerable tax benefits as with cattle. . .

"Animals held for breeding are treated the same as other livestock such as cattle. . .

"Continued losses are a problem and always subject to scrutiny. . . . Breeding, racing, and the showing of horses have always been suspect, particularly when conducted by a high-bracket taxpayer that endeavors to write the losses off against other income . . . As with cattle, the decision turns on the subjective motives and profit potential of the owner. . . Country estates and small operations are in the face suspect. The more attention paid to the business and the professional manner in which the business is operated are all plus factors."

I shall turn now to some of the more common allegations made by those who oppose my bill. For example, there are some who say that the bill would force farmers to use the accrual system of accounting; that the bill would prevent the successful farmer or rancher from engaging in nonfarm operations with outside income for fear of losing his right to deduct farm losses; that the bill would discourage the flow of outside money into ranching and farming operations and so on.

I have repeatedly denied these allegations. Statistics reveal that there are a comparatively few taxpayers who enter into farming as a tax-dodge device. The 32-page report, "Statistics of Income -- 1967, Preliminary, Individual Income Tax Returns," published on 14 January of this year reveals that in 1967 there were approximately 770 thousand individual income tax returns filed that reported a net loss from farming. My bill would affect in the neighborhood of 14 thousand or slightly less than 2 per cent of those returns. This is statistical evidence that my bill will only affect the tax-dodge farmers who are currently distorting the farm economy.

In discussing statistical evidence of this problem, the Treasury's two-year study, published on 5 February of this year, points out that a growing body of investment advisors is currently advertising that they will arrange farm investments for high-bracket taxpayers to enjoy deductions on dollars that are really spent to acquire capital assets. It is because of that kind of advertising that people are being drawn to farm "tax-loss" situations.

Just last year I saw an ad in a magazine called the Airline Pilot that read in part -- "Own a citrus grove using tax dollars as your total investment, . . ." The ad was headed "Tax Shelters for 1968." You can pick up the Wall Street Journal on any given day and find ads of this type. For example, the other day I came across one that read in part: "Pistachio Nuts, The Green Nut with the Golden Future . . . Outstanding opportunity for land investment and Pistachio nut tree planting program. . . Most of growing costs deductible."

As I evaluated each of the proposals pending before this Committee, I must admit that I have become even more convinced that the fairest and most effective way to get at this problem is to adopt the loss limitation approach contained in S. 500. Here is a unique opportunity to scale down the long run revenue loss that results from the sum total of all the provisions of the 368-page House bill while at the same time we increase substantially the equity of our tax laws through a healthier farm economy.

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STATEMENT ON BEHALF OF

AMERICAN HORSE COUNCIL, INC.

Submitted by THRUSTON B. MORTON, President, and GEORGE A. SMATHERS, General Counsel, before the UNITED STATES SENATE FINANCE COMMITTEE on September 22, 1969.

SUMMARY OF THE STATEMENT OF THE AMERICAN HORSE COUNCIL, INC.

1. The American Horse Council, Inc., an organization of some 200,000 members, consisting of most of the major horse associations in the United States is unalterably opposed to the farm tax provisions contained in Sections 211, 212 and 213 of H. R. 13270.

2. These provisions, if enacted into law would constitute a serious threat to much of the $12 billion horse industry in America.

3. At stake in that industry are (a) the interests of the 187,000 young boys and girls in 4-H horse projects (b) the well being of thousands of horse breeders-farmers who have no special federal subsidies (c) the investment of capital in rural communities which has created many thousands of jobs for the people of these areas making it possible for them to stay out of our overcrowded cities (d) the horse racing industry which returned $427 million to the 30 states where parimutuel betting was in operation in 1968 and (e) the school, scholarship program, hospitals, police and fire protection, new parks and play grounds that these millions make possible.

4. Congress has always championed incentives for the farmer. Since 1915 it has fought for the right of farmers to use the simplified cash method of keeping books. As recently as 1962, Congress specifically exempted livestock from Section 1245 - the depreciation recapture rule applicable to personal property.

5. The problem arises today because much publicity has been focused upon what is said to be a great "loophole" in the law. Yet the proposed remedy contained in the farm provisions of H.R. 13270 would raise only $5 million in 1970. This constitutes only 3/1000 of 1% of the $154 billion in taxes collected by the Federal Government last year. Furthermore for the past 3 years the number of returns showing farm losses declined at the rate of 25,000 each year. The problem is thus insignificant compared to the overall problem of collecting billions in taxes and closing giant loopholes.

6. We believe the answer lies not in new legislation but in more strongly enforcing the present law such as Section 165 which prohibits the deduction of all farm losses unless a farm is being operated "for profit."

Thruston B. Morton, President, and George A. Smathers, General Counsel, submit the following statement on behalf of the AMERICAN HORSE COUNCIL, INC.

I. INTRODUCTION

The American Horse Council is an organization of some 200,000 people who have joined together in the common goal of promoting the interests of the burgeoning horse industry of our nation. It was formed to define and implement programs to meet the immediate and long-range needs of the industry particularly those concerned with medical research; studies in regard to its economic impact and contribution; and familiarizing the government and the general public with the industry.

The cohesive factor in the membership of our organization is horse ownership and a direct interest in the horse industry; our ranks cut a wide swath across our country's economic scale, both individual and businesses. Among the associations that have joined in forming the Council are the American Andalusian Association; the American Hackney Horse Society; American Horse Shows Association, Inc.; American Quarter Horse Association; American Saddle Horse Breeders Association; Appaloosa Horse Club, Inc.; Arabian Horse Club Registry of America, Inc., Morgan Horse Club, Inc.; National Association of State Racing Commissioners; The Jockey Club; The Pinto Horse Association of America, Inc.; The United States Trotting Association; Thoroughbred Breeders of Kentucky, Inc.; and Thoroughbred Owners and Breeders Association.

A. The Horse Industry

It is estimated that there are approximately seven million horses in America. The industry has lived through a virtual revolution in the past 25 years. It has now become a major factor in our economy. According to the Department of Agriculture, horse owners spend $5 billion a year just for items such as feed, drugs and equipment.

Added to that are the moneys generated by breeding farms, payrolls for allied industries such as the manufacturers of saddles, horse-shoes, trailers, boots, hats, etc. Additional millions are spent in travel costs to attend horse shows, racing, rodeos and other horse events. The Department of Agriculture has estimated the size of the total horse industry at $12 billion.

B. Contributions of the Horse Breeder

At the heart of this great industry is the breeder of horses. Without him, we would not have witnessed a five million head increase in the horse population in the last quarter century. And without his continuing operations in the future, the industry would slip back into the deteriorated condition it found itself in during the early 1940's.

Horse breeders are often glamorously portrayed as men of great wealth -- owners of luxurious stables and million dollar studs.

On the contrary, the average breeder of horses -- race horses, pleasure horses, quarter horses, trotting horses, children's ponies -- this average breeder more closely fits the mold of the average farmer.

For in fact, the horse breeder is a farmer. The product of his work -- like farmers who till the soil and those who breed livestock -- is subject to all the vagaries of weather, market fluctuations and, perhaps most importantly, the unpredictability of his crop. One wrong decision during a four year interval can spell disaster for him, just as it can for other breeders of livestock. There's no sure way of knowing in advance which of his foals are going to fall victim to disease or injury or some late developing physical disability. In good times and bad, he has to continue to buy feed, fence posts and fertilizer.

The farmer who breeds horses doesn't enjoy price supports from the Federal Government; he doesn't share in incentive payments such as those afforded to the sheep industry; unlike the dairy and beef industries he has no protection from excessive foreign imports.

The horse breeder has asked for no subsidies from the Federal Government. And he has none. Yet, along with other farmers, he feels the pinch of the skyrocketing costs of farm production.

The citizen who devotes his life and money to breeding horses is making a contribution to the well-being of rural America. He is providing jobs, purchasing power and healthy recreation for our people. He is supporting the 187,000 young boys and girls in 4-H horse projects. He has helped to transform dying rural areas into vibrant places to live and work and raise a family.

In the last several weeks, we have heard the term "outside capital" in farming maligned. It has been used interchangeably with "tax gimmickry". We need to remember what capital invested in horse breeding, pure bred livestock operations, and crop improvement has meant to communities where it has been invested.

Henry Matthiesson remembers. He and his father have been cattle farmers in the Blue Ridge Mountains for the past 43 years. He has seen new capital come on the land and make it better -- better for farming and better for the people who live and work in the valley they call home. Here is the way the former president of the American Hereford Association described it to the Ways and Means Committee:

> "I look back on the origins of the farming community in which I have lived. There are perhaps a half dozen large farms in the small valley today; this, in place of perhaps 20 or 25 farms forty years ago. Most of that land was in the hands of banks in those days, and lying unfarmed. Today, there are perhaps an average of four to six farm families working on each of those farms, making a regular, secure living, and these farms are responsible for much of the prosperity of business in the neighboring communities. Much of that valley was an overgrown wilderness, 'farmed out,' when we came there, with none of the modern machinery and know-how that is available to it today. Someone put money in it forty years ago, or it would still be marginal support. That application of capital did not wreck that farming community or drive people out of it, it preserved the community and the people and made it better."

C. The Horse Racing Industry

The owners and breeders of race horses are making a unique contribution to our economy. Like all other horsemen, they enjoy no federal subsidies. On the contrary, they are subsidizing substantial tax revenues in the 31 states where a parimutuel betting system is in operation.

In Illinois, for example, horse racing returned $40 million to the State treasury in 1968. In New Jersey the figure was $34.4 million; California $57.3 million; and New York $155.7 million.

These moneys support schools, scholarship programs, hospitals, police and fire protection, new parks and playgrounds. They help make the community a better place to live.

Take those millions out of a state's treasury and one of three things must happen: Either state ad valorem taxes will have to go up; or the Federal Government will have to increase state aid programs; or the quality of life will suffer.

This state tax revenue is always substantially greater than the total purse winnings of horse owners and the income to race tracks combined. In thoroughbred racing last year, total tax revenue exceeded total purse distributions by $160 million.

The cost of maintaining all thoroughbreds in 1968 was greater than all purse distributions by approximately $193 million.

It is apparent then that the horse racing industry is largely subsidized by the owners. Because of their willingness to invest in such a high risk venture, state and local governments can do more for their people.

II. THE CONGRESS HAS ALWAYS SUPPORTED FARM INCENTIVES

Historically, the Congress of the United States has always recognized these values that farming and ranching contribute to the betterment of our society.

Congress has also long been aware that our oldest and largest industry has not yet found its place in the sun -- that farming has not shared

in the prosperity of our economy generally. Congress has, therefore, deliberately written into the law certain provisions which it felt were essential for the farming and ranching industries.

For example, after capital gains provisions were added to the Code in 1942, the Treasury Department, concerned as always only with the amount of revenue returned to the government, tried for nine years to exclude breeding livestock from property that would qualify for capital gains treatment.

Restrictive Rulings were issued by Treasury in 1944 and again in 1945. Notwithstanding a 1949 Court of Appeals decision to the contrary, Treasury persisted. However, the Conference Committee of the House and the Senate meeting on the Revenue Act of 1950 directed that the Treasury follow the Court's ruling.

The following year, in 1951, the Congress, after deliberation, specifically applied capital gains treatment to livestock held for 12 months or more for draft, dairy or breeding purposes.

When the Congress amended the so-called hobby law in 1954, it recognized that the provisions written into the original amendment ten years earlier could "penalize bona fide business and enterprises." The Congress excluded, therefore, certain costs from computing the basic $50,000 loss figure, among which were those costs that farmers have traditionally been permitted to expense or capitalize.

In 1960, Congress added soil and water conservation, and in 1962, land clearing, to those costs which a farmer can expense or capitalize.

Also in 1962, when Section 1245 was added to the Code, Congress deliberately provided that livestock would not be subject to the recovery of depreciation rules.

A. Cash Accounting

Perhaps in no other tax area has Congress demonstrated greater concern for the farmer than in its insistence down through the years that the farmer may use a cash method of accounting.

Congress has always recognized that the accrual accounting method would impose new and complex difficulties and significantly greater

costs on the farmer who is already besieged with an almost untenable burden of ever higher production costs, and low prices for his product.

Congress has, therefore, always fought for the cash method for farmers to help him avoid the necessity of keeping elaborate books and records and the almost impossible burdens of maintaining inventories and properly allocating costs.

Farmers have historically managed their farm operations on a cash basis. The Congress has long recognized this practice as a fact, and 54 years ago, two years after adopting the Sixteenth Amendment to the Constitution, which authorized the personal income tax, approved the Treasury regulations authorizing the right of farmers to operate their farms on a cash basis.

In fact, up until 1958 the Treasury <u>required</u> farmers to use cash accounting, if they did not keep complete and precise records. Treasury Regulations further say that the farmer is among those taxpayers who are not expected to keep detailed books of account.

The Treasury Department recognizes the difficulties that an accrual system poses for the farmer. It has, for example, set out in the Regulations how gross profits of a farmer are to be ascertained.[1] It has permitted an exception to the general rule and allowed the farmer to inventory his animals held for draft, dairy and breeding purposes along with those held for sale.[2] It has provided special inventory valuation methods for farmers.[3]

For the past eighteen years, the Congress has steadfastly resisted numerous attempts by Treasury Department officials to require farmers to give up the cash method.

When Congress acted in 1951 to assure that breeding livestock could qualify for capital gains, the following language of the Ways and

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[1] Sec. 1.61-4

[2] Sec. 1.61-4 (b) (7)

[3] Sec. 1.471-6. (A farmer on the cash method may not inventory; one on the accrual method must. (See 1.61-4(b))

Means Committee Report was emphatic in its insistence that Treasury not force the farmer to give up tne cash method:

> "Your Committee believes that the term 'livestock' should be given a broad, rather than a narrow interpretation; and that the gains from sale of livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and presently recognized by the Bureau of Internal Revenue."

The Senate Finance Committee was also unequivocal in laying down guidelines it expected Treasury to follow:

> "Your Committee believes that the gains from sales of livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and presently recognized by the Bureau of Internal Revenue."

Following this action by the Congress, the Secretary of the Treasury sent a letter to the then Chairman of the Senate Finance Committee, Senator Walter George of Georgia, requesting that the Congress approve legislation giving the Department the authority to require farmers to adopt the accrual method. Senator George and the Committee refused to accede to the Treasury request and took no action.

In the President's Tax Message to Congress in 1963, the matter was again brought up. The Treasury Department, in its appearance before the Ways and Means Committee that year, urged that farmers who made over $15,000 in non-farm income be required to establish an "Excess Deductions Account," made up of farm losses less gains. Gain from the sale of capital assets would be treated as ordinary income to the extent of the amount in the account. The effect of this proposal would have been most onerous to the small cash method farmers.

The Treasury was once again notably unsuccessful in changing the long-held position of the Congress about this matter. The Ways and Means Committee refused to act.

III. THE PROBLEM TODAY

Today we find these farm tax provisions once again under attack. It is said that some people are abusing the law -- that they are putting money into farming as a "tax gimmick" -- scavenging, so to speak, on the cash accounting method and other provisions Congress has authorized to help the farmer.

It is being said that this constitutes a great "loophole" in the tax laws; that this so-called "loophole" should be closed not by attacking the "tax gimmick operator," but by changing the whole system of farm accounting which Congress has consistently fought to preserve.

At the outset, we should ask ourselves how big is this problem that some say requires extreme remedies in order to cure? The Federal Government collected a total of $154 billion in taxes last year. The largest estimate of revenue loss that this particular problem involves -- $145 million -- was made by Mr. Surrey. If we accept his estimate, it amounts to less than 1/10 of 1% of the total revenue collected. The spokesmen for the new Secretary of the Treasury estimate that his proposal to solve this problem would raise $10 million in 1970. This comes to less than 1/100 of 1% of the total revenue collected. The proposal passed by the House of Representatives would increase revenues by $5 million in 1970. This represents 3/1000's of 1% of the total revenue collected.

Furthermore, in the last three years the number of returns showing a farm loss declined at the rate of almost 25,000 each year.

We submit, therefore, that this is really an insignificant problem when compared with the overall problem of collecting billions in taxes and in closing giant loopholes. The Surrey proposal pointed to only 2,600 tax returns of wealthy people as the maximum that could be involved. We say could be, because no one has ever claimed that all of those are "tax gimmick" operators, rather than honest, hard-working farmers and ranchers who suffer losses in the legitimate pursuit of improving horse breeds or cattle breeds or crops.

A. What is the Answer?

But even if, out of three million farmers, these 2,600 were all violating the law -- the question arises as to what we are going to do to stop it. Do we change the laws which Congress has insisted

upon for the benefit of the farmer for 54 years? Do we thus jeopardize the already precarious position of agriculture? Has farming reached such a level of prosperity that we should take away any advantages it may presumably have? We don't think so. We believe that this Congress should and will think as have the other Congresses of the past; that is to say that this is a minor problem that the Treasury presents; that the farmer should not be pilloried and abused; that the law should remain as the Congresses of the past intended it to be.

We recognize that every law the Congress writes -- and particularly tax laws -- are in time circumvented and abused by a few of the astute and ill-intentioned operators. But we don't think, to quote the ancient aphorism, "we should burn down the barn to catch a few rats." We believe that the answer lies in enforcing the laws already on the books.

We believe that these people who allegedly engage in farming to scavenger on the traditional and essential farm provisions are not covered by the provisions of the law under which they operate. Most of them would fail the "intent tests" spelled out in Sections 1231(b)(3) and 165.[4] There is no doubt that the Treasury Department can move effectively against questionable farm losses. In fact, such losses are now being questioned by the Internal Revenue Service in 47 cases presently pending in the Tax and District Courts under Section 165.

Some of these "tax gimmick" operations are also subject to regulation as investment contracts by the Securities and Exchange Commission. The SEC has already asserted its authority in similar ventures involving beaver, mink and fox.

Therefore we believe it would be a far wiser course for the government to move vigorously under present law against violators of those laws. To change these laws, as proposed, would be to punish all three million farmers in America for the wrongdoing of a few.

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[4] Under 1231 (b) (3) livestock must be held for one year <u>for draft, dairy or breeding purposes</u>. If they are not held for <u>one of those purposes</u> they do not qualify for capital gains. Under Section 165 a farm must be operated "for profit" in order for losses to be deductible.

IV. ALTERNATIVE REMEDIES ADVANCED TO MEET THE PROBLEM

Let us examine what is proposed as remedies for this problem:

A. The Surrey proposal would limit to $15,000 per year the amount of farm losses that could be offset against non-farm income by any farmer who did not adopt the accrual method and capitalize all costs which can now be expensed or capitalized at the taxpayer's option.

B. The Metcalf Bill (S. 500) also applies to any farmer who does not adopt the accrual method and capitalize all costs which can now be expensed or capitalized at the taxpayer's option. Farmers who do not comply with these conditions would lose their right to offset farm losses against non-farm income on a dollar-for-dollar basis to the extent that non-farm income exceeded $15,000. Thus, a farmer having a $30,000 non-farm income, could deduct no farm losses against his non-farm income.

C. The Miller Bill (S. 1560) simply disallows all farm losses, (except those attributed to a casualty or research) to any farmer who does not derive at least 2/3 of his total net income from farming. It applies irrespective of whether the farmer is on the cash or accrual method.

D. The Treasury Tax Reform Proposals of April 22, 1969, would:

(1) Make the accrual method and capitalization of expenditures such as for soil and water conservation, fertilizer, and land clearing costs (which can now be expensed or capitalized) the standard for determining farm losses which must be included in the computation of "preferences" under the "Limit on Tax Preferences" proposal. Cash method farmers would have to recompute their losses on the accrual method and the difference would constitute "preferences." Farm capital gains could not offset farm losses in the determination of "preferences." (Under the "Limit on Tax Preferences" proposal, a taxpayer can claim certain exclusions and deductions now allowed in full, only to the extent that such "preferences" do not exceed 50% of his total income. In other words, such preferences would be taxable to the extent that they exceeded his income subject to tax from all other sources.)

(2) Livestock was excluded from the depreciation recovery provisions of Section 1245 when the law was enacted in 1962. This exception would be removed, meaning that gain on the sale of livestock to the extent of prior depreciation taken would be treated as ordinary income.

(3) The holding period for livestock <u>other than race horses</u> would be extended from the present one year to the shorter of two years or 2/3 of the expected useful life before sales could qualify for capital gains.

(4) Race horses would qualify for capital gains only if (a) "in the hands of a breeder" they had actually been bred or (b) they were used "in the racing business" for two or more years.

(5) Farmers on the cash method would have to establish an Excess Deductions Account (EDA). All losses in excess of $5,000 would go into the account. The account would be reduced by net ordinary farm income in subsequent years. The proceeds of the sale of capital assets would be treated as ordinary income to the extent of the amount in the account in the year in which the sale is made; for example, a taxpayer loses $100,000 in 1969. $95,000 goes into his EDA. In 1970 he sells off livestock which would ordinarily give him a capital gain of $200,000. $95,000 is treated as ordinary income and the $105,000 is capital gains.

(6) Under the Hobby Law (Section 270), certain deductions are disallowed when a taxpayer incurs net losses in excess of $50,000 for five consecutive years. Treasury recommended that the time period be changed to "any three of five consecutive years."

E. <u>The House-passed bill, sections 211, 212 and 213 of H.R. 13270, would provide as follows:</u>

(1) A new hobby loss provision (Section 270) would disallow the deduction of <u>all</u> legitimate expenses from any business activity carried on "without a reasonable expectation of profit."

Heretofore, the law has always been based upon the "intent" of the taxpayer to make a profit. Under this new provision, the IRS will be permitted to decide whether the taxpayer's <u>intention</u> was <u>reasonable</u>. This would be a dramatic departure in the law and one that would cause undue hardships, uncertainty, and necessitate costly and time-consuming litigation.

(2) An Excess Deductions Account (EDA) will be required to be established which will cause taxpayers to report as ordinary income what would otherwise be classified as capital gain. This change in the tax rate could be the difference between a 25% and a 70% bracket. All taxpayers who make in excess of $50,000 in non-farm income and whose farm losses exceed $25,000 will be required to establish an Excess Deductions Account. Losses in excess of $25,000 would be entered in the EDA. To the extent of the amount in the EDA, capital gains from the sale of farm assets would be treated as ordinary income. In effect, this could increase a horseman's taxes by almost 200% under the present law.

(3) Depreciation claimed for livestock would be "recaptured" when the animal is sold. Thus, gain on the sale of livestock would be treated as ordinary income, rather than capital gain, to the extent of depreciation deductions previously claimed.

(4) Livestock would not qualify for capital gains treatment until it was held at least one year after the animal normally would have first been used for draft, dairy, breeding or sporting (such as horse racing) purposes.

F. The Treasury Department proposed to the Senate Finance Committee on September 4, 1969 that the farm provisions of H. R. 13270 be amended as follows:

(1) That the Excess Deductions Account rules apply to any farmer whose non-farm income exceeds $25,000 and whose farm losses exceed $15,000. In such a case, all farm losses should be included in the E.D.A.

(2) The term "profit" in the proposed new hobby loss provision should "be specifically defined to include not only immediate economic profit but also any reasonably anticipated long-term increase in the value of property."

V. THE PROPOSED REMEDIES WILL HURT THE AVERAGE FARMER

All of these proposals fall into the following categories:

(a) threat to the cash method of accounting;
(b) limitations on the option to expense or capitalize certain costs;
(c) restrictions on Section 270, the hobby law;
(d) limitations on non-farm income

Let us look briefly at each of these categories.

(a) Our response to the attack upon the cash method farmer is that the issue for the past 20 years has been between the technicians down in the Treasury Department who obviously want to increase tax revenues, and the Congress of the United States which looks at the broad spectrum of what is best and, indeed, what is essential for America's three million farmers.

Congress has always put the welfare of the average farmer first in its deliberations. We don't believe the sordid story of a handful of tax dodgers is going to persuade the Congress that attacks upon the farm community and farm traditions are an appropriate response.

(b) The Surrey and Metcalf proposals provide that, in addition to giving up the cash method, farmers may not offset farm losses against non-farm income unless

they also capitalize all costs which the Congress has heretofore permitted the farmer the option of either capitalizing or currently deducting. These include costs of soil and water conservation, fertilizer and land clearing.

The Treasury proposal calls these expenses "tax preferences" upon which it would place a 50% limitation.

Congress just added the soil and water conservation provision to the Code in 1954. The provision on fertilizer was added in 1960 and that with respect to land clearing in 1962. Have conditions for the farmer improved so much in the past seven years that these provisions are no longer needed by the farm community? It is impossible for us to believe that the Congresses of recent years who wrote these provisions into the law for the benefit of farmers were so ill-informed or short sighted.

(c) The present hobby law provides that if losses in a trade or business exceed $50,000 for five consecutive years, the individual's tax is re-computed for each of those years and limitations are placed on the amount of loss that can be deducted. In computing the $50,000 loss figure, certain deductions are exempted by law. For example, in 1954, Congress excluded from hobby loss computations those expenditures which may, at the taxpayer's option, either be capitalized or deducted when incurred.

The Surrey proposal called Section 270 "ineffectual." However, a few years ago, while teaching at Harvard, Mr. Surrey posed this question about Section 270:[5]

> "...<u>how can it be withdrawn without affecting the genuine business activities of an individual with his finger in many pies, or those genuine activities carried on by individuals which generally show red figures for the initial years because of the nature of the business, such as horse breeding, fruit raising, mining or</u>

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[5] "Federal Income Taxation, Cases and Materials, " Stanley S. Surrey and William C. Warren, The Foundation Press, Inc., 1955

<u>hotel operation or may suddenly show losses for several years due to adverse conditions</u>. . ."

Thus Mr. Surrey pointed a finger at the heart of this problem. It takes 6 to 7 years before new citrus trees begin to bear fruit. The cycle in purebred livestock operations is 5 years. There is a three year lapse from breeding until a race horse is even eligible to enter a purse race. All of these investments take time before they, hopefully, begin to show a profitable return.

After 25 years experience with Section 270, including at least one relaxation of its potentially penal characteristics, we believe that the Congress will finally decide against tightening its restrictions. If the law were changed, as has been proposed, it is a certainty that many taxpayers, who are making great contributions to our people as a result of their research investments into the rural communities of America, will be driven out of these areas.

(d) The proposals that limit the right to deduct <u>farm losses</u> against non-farm income seriously damage and restrict the operations of the long-time genuine farmer.

In today's farm economy, the farmer is increasingly turning to off-the-farm supplementary income. In so doing, he is simply following the recommendation of the Farmers Home Administration, which, through its predecessor agency, began urging the farmer to diversify his farm operations when the agency first opened in 1933. For the past decade, the admonition has been to diversify not his farm but his source of income.

The success of these efforts is reflected in a recent address by Dr. M. L. Upchurch, Administrator of the Economic Research Service, U.S.D.A.:[6]

"Off-farm income has become an increasing factor in the life of farm families. <u>In 1967, the farm population</u>

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[6] Before the Annual Agriculture Outlook Conference, February 18, 1969.

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> got $13 billion net from farming and $10.7 billion from non-farm sources. On the average, each farm operator family received $4,526 net from farming, and $4,452 from non-farm sources. Non-farm income per farm family more than doubled between 1960 and 1967."

If this rate of increase continues in the future, and it will probably accelerate if tax incentives are granted for industry locating in rural areas, the non-farm income of the average farmer will exceed $15,000 in 13 years. If the Metcalf or Surrey proposals were adopted, the average of all three million farmers in America would then be forced to relinquish the cash accounting method they have been able to operate under since 1915 or be denied the right to offset farm losses against their non-farm income.

The strange anomaly of these proposals is that if the farmer proved to be more successful at farming than he was in his other business investments, he could continue to deduct all his business losses against his income from the farm. We believe that fairness and equity require that the principle should work equally in either direction.

VI. THE QUESTION OF LAND VALUES

The Surrey proposal states that "the price of farmland (is) beyond that which would prevail in a normal farm economy." In effect, it says the price of farmland is too high. Senator Metcalf acknowledged that his proposal would bring farmland prices down "in some areas."

We don't believe there is any citizen, either on or off the farm, who wants the land he presently owns to decline in value. With lower land value, the farmer who desires to expand into contiguous acreage, will have less collateral to offer. Banks will be reluctant to loan money. The percentage of the selling price the farmer can get on a purchase money mortgage will decline. He will need more cash for a down payment. If he hasn't got it, and there's equity in his existing holdings,

he can put up the land he already owns as collateral. But with declining values, it may not be enough, particularly if, like the average American, he already has that homestead under mortgage. He'll find the same problem when he wants a loan for new equipment, or operating capital.

The many farmers who have been able to sell out to land developers, pocket an amount of money they could never have realized from farming, and move further out into the country where they can and do buy more acreage at a fraction of the price they sold for, have not been heard to complain of increased land values. They can do a lot of things for their wives and children they otherwise could not have done. They can upgrade their total standard of living. They can be sure that their children get the best education.

One of the arguments used by the sponsors of these proposed changes is that outsiders with money come in and buy up land so that locals can't buy it. Surely there is little logic to this. The farmer who covets his neighbor's land does not want the value of his land to diminish. Surely he should realize that as all our people grow more affluent, have more leisure time, they will normally move back to the farms or ranches as a second home, and of course this increases the price of the land -- his neighbor's and his own. This movement upward of land values, we submit, is desirable overall -- surely it's better than a downward movement. To allege as some do that "outsiders," "tax avoiders" drive up the price of land and hurt the legitimate farmer, is to ignore the facts of our growing population, our growing wealth, our growing leisure time, our growing opportunities to enjoy the long-sought "country life."

VII. THE FARM COMMUNITY NEEDS OUTSIDE CAPITAL

Implicit in these proposed changes is the belief that outside capital which is good and desirable for all industries is somehow harmful to farming.

Completely overlooked are all the benefits that investment capital have meant to the farmer, the rural community and to the American people in general.

Outside capital built American agriculture. It made new technology possible. It has helped to produce the finest beef and the finest citrus of the world. It seems incomprehensible to suggest that we should, all of a sudden, stop our improvements in the food and nourishment we eat -- any more than we should stop the investment of capital in the production of championship race horses which attracted over 65 million people to watch organized racing last year resulting in $427 million in state tax revenues to 30 states.

You can't breed an animal and raise a mature offspring ready for the track or the market overnight, anymore than you can plant a seedling and expect a crop the next day. All this takes time -- and money. Farm research, like research in every other industry in America, is considered part of the overhead. It is not expected that research will immediately return a profit. But it is essential for the continued growth and development of the farm industry. Take the research dollars out of the space industry and we'll never put an American on the surface of the moon. Take research out of agriculture and the results will have a far more direct and immediate effect upon the pocketbooks and the dinner tables of all Americans. Take dollars away from rural communities and our rural citizens will be forced to move, in greater numbers, into our already overcrowded urban areas.

The Congress won't do that. As a matter of fact, it has numerous bills pending before it today to sweeten tax incentives for industry that move into rural areas. One of these is the Rural Job Development Act (S.15) introduced by Senator Pearson and co-sponsored by 35 senators. We don't think Congress really wants to <u>increase</u> incentives for all other rural industry and simultaneously <u>decrease</u> incentives for farming.

We applaud the purposes of S.15, but does it make sense to ask the Congress to establish new incentives for industries that move into rural communities and provide jobs, while, at the same time drive other businesses and individuals who are now supplying jobs out of our rural communities?

Our reading of Senator Pearson's bill leads us to believe

that the incentives it calls for would be available to farm investors as well as investors in other rural industry. This is as it should be.

The Congress has already created a Small Business Investment Company industry, to stimulate outside capital into small business. This industry has generous tax advantages which include the authority to write off certain capital losses against ordinary income. Perhaps a Small Farm Investment Act, with equally generous tax advantages, would portend an era of general prosperity for the farmer, especially the family farmer, that has somehow eluded all prior efforts.

VIII. CONCLUSIONS

The farming community today is beset with many problems. With production costs at an all-time record high and parity at only 73%, the farmer is getting far less of a return for his efforts than he deserves for having produced the best beef and pork and vegetables and citrus for the American family dinner table.

The farmer needs help. His industry needs stimulation. It needs innovation. It needs research, it needs capital -- it needs money. Surely this is no time to be taking money out of the farm community.

Somehow, we need to extract the finest principles of other industries that have made this country the free enterprise model of the world, and apply them to a new revolution in agriculture that would truly benefit all the three million big and little farmers in America.

What the farmer doesn't need is further restrictions and encumbrances that would inevitably diminish his opportunities to achieve success in his chosen field -- what he needs is a greater opportunity to achieve a parity with the rest of our prosperous economy.

We don't believe that the farmer who happens to lose money should be identified with or bear the blame or suffer the consequences of a handful of people who are "tax gimmick operators."

It is they -- and not the farmer -- against whom action should be taken. There are laws on the books today to put the "tax dodger" out of business. Section 165 of the Internal Revenue Code prohibits the deduction of any losses from a farm that is not being operated for profit. If laws such as these were vigorously enforced, as they should be, we would not have to be considering ways to diminish the few incentives that the farmer, thanks to an understanding Congress, enjoys today.

S U M M A R Y

Statement by Louie B. Nunn, Governor, Commonwealth of Kentucky, before the U. S. Senate Finance Committee, Monday, September 22, 1969.

Proposed legislation before the Congress would have a detrimental effect on the national horse industry and thus would materially and adversely affect the economy of Kentucky as well as several other states, Governor Louie B. Nunn told the Senate Finance Committee.

Armed with a report from Spindletop Research, Inc., of Lexington, Kentucky, the Governor strongly implied that the impact of the many contributions of the horse industry would be significantly lessened should proposed legislation be approved.

He cited the following supportive evidence:

-----More than half of Kentucky's tourist industry, which last year contributed $43 million in tax revenue to the state, results directly or indirectly from the horse industry.

------Labor utilized for commercial horses alone in the categories of breeding, training, racing and showing amounts to more than 125,000 full-time jobs.

------Between 25,000 and 33,000 full-time jobs are created among the supportive services and supply industries for horses.

------Known total annual wages for horse industry labor and related service and supply vendors amount to $1 billion.

------Total capital investment in the commercial horse industry is $2.34 billion.

------1.9 million acres of land valued at $1.26 billion is devoted to commercial horse uses.

------The horse industry in 1968 generated $426.9 million directly to the states in revenue from pari-mutuel wagering and $18.9 million in other taxes paid by race tracks.

------Recreation, conservation of aesthetic values and education are other facets of the horse industry important to any consideration of detrimental legislation.

"The horse industry provides jobs at a time when we are seeking solutions to unemployment. It generates substantial revenue directly to the states at a time when you are being asked to provide federal revenue to the states," Governor Nunn said.

"Let me make it abundantly clear to you that I am not here today to ask for special favors for Kentucky or for special treatment for the Kentucky horse industry," he added.

"At the same time, however, I would urge you to take care that you do not 'throw out the baby with the washwater'," Governor Nunn said.

STATEMENT OF LOUIE B. NUNN, GOVERNOR OF THE COMMONWEALTH OF KENTUCKY, BEFORE THE SENATE FINANCE COMMITTEE, MONDAY, SEPTEMBER 22, 1969.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Louie B. Nunn, Governor of the Commonwealth of Kentucky. My purpose for appearing before this distinguished Committee is to present facts and statistics on proposed legislation which would materially and adversely affect the economy of my own state and that of twenty-six (26) additional states that are involved in horse racing or breeding.

In addition to the 27 states to which I refer, others who will make presentations to this Committee no doubt will give further information as to how this proposed legislation would affect them.

Realizing the importance and the significance of the proposed legislation and the limited time resulting from the tremendous workload of this Committee, my remarks shall be brief and to the point.

Kentucky has achieved a position of worldwide preeminence in Thoroughbred, Standardbred, saddlebred and quarter-horse breeding and racing.

While these endeavors are most drastically affected by the legislation that you must now consider, they are not the only areas about which we have the greatest concern.

Other testimony no doubt will dwell on the detrimental effect that H. R. 13,270 will have on the cattle industry and other phases of the suffering farm economy, but in passing, I would only relate that my state ranks 10th in the nation in the production of cattle and dairy products.

Therefore, my interest is not directed toward a single purpose. Indeed, even though I shall make frequent reference to my own state, this legislation is of such wide geographical and economic concern that I am sure any number of Governors could appear before you and many of them stand ready to do so if your time permits.

Let me make it abundantly clear to you that I am not here today to ask for special favors for Kentucky or for special treatment for the Kentucky horse industry.

My purpose is to outline the importance of the horse industry in the United States and to help the members of this Committee to weigh carefully the consequence of the various tax changes that have been proposed.

My statement is not mere conjecture or verbage. It is based on statistics developed by Spindletop Research, Incorporated, a not-for-profit, independent research institute established to stimulate the economic and industrial development of Kentucky and its region.

Spindletop has engaged in many projects that relate to Kentucky's most important industries, as well as having done work for the federal government and many private enterprises.

The study entitled "Economic Importance of the Horse Industry in the United States" was performed as a special public service in hope of clarifying some of the questions and misconceptions surrounding the horse industry. Attached to this statement and to be filed herewith is the complete text of the Spindletop Research report.

When viewing the horse industry from a national standpoint, it is necessary to consider not only its economic importance, but also its recreational and educational significance.

Directly affected are those who engage in the commercial activity of the horse industry. This includes breeding, training, racing, and showing, since people in these activities make their living directly from working on or with horses. In other words, horses are the tools of their trade.

Indirect commercial activities are conducted by the manufacturers and suppliers who furnish products and by professional people who furnish services for either commercial or recreational horses.

Therefore, the total horse population can be considered applicable to indirect commercial activity.

TOURISM

Furthermore, in some areas of the country, especially in Kentucky, the tourist industry is considerably strengthened by substantial numbers of visitors to our famous horse farms.

Last year alone, the tourist industry resulted in $43 million dollars in direct taxes being paid into our state's economy. The horse industry was responsible, either directly or indirectly, for attracting more than fifty (50) per cent of this amount.

The most difficult factor to measure in terms of the recreational aspects of horses is the tourist potential for horse farms, horse shows, racing and rodeos.

There are certainly many secondary factors that merit consideration, such as the extra time that families spend in an area because of these

attractions, the extra distance traveled to view or participate in these activities, and the promotional value of the image created by the horse recreation activities.

COMMERCE

In 1968, the total horse population of the United States was estimated to be in excess of six (6) million. Of this total, 1.2 million horses were known to be registered. Of the registered horses, 832 thousand were listed as recreational and over 428 thousand were listed for commercial purposes.

The labor utilized for commercial horses alone in the category of breeding, training, racing and showing amounts to more than 125 thousand full-time jobs.

In addition, there are between 25 thousand and 33 thousand full-time jobs in the supportive services and supply industries for all horses, bringing the total employment to more than 150 thousand full-time jobs, with many

more persons employed throughout the year on a part-time basis. Much of this employment is in the agricultural sector.

The known total annual wages for this labor amounted to more than $727 million dollars.

Wages paid by service vendors and suppliers were approximately $250 million dollars. Thus, this proposed legislation would adversely affect total annual wages of $1 billion dollars.

CAPITAL INVESTMENT

Total capital investment in breeding facilities and equipment is $543 million dollars. An additional $79 million is invested in training, $602 million is invested in race tracks. The value of the commercial horse is $1.12 billion dollars.

This adds up to a total capital investment of $2.34 billion dollars. Although substantial, this figure must be considered only a very conservative estimate, in as much as there are many items of equipment such as horse trailers which could not be estimated with any degree of precision.

LAND USE AND VALUES

Land devoted to commercial horse uses in 1968 amounted to more than 1.9 million acres having a total value of $1.26 billion dollars. I would remind you that these values apply only to those portions of farms that are devoted to commercial horses.

The statistics make it abundantly clear that this extensive industry employs a large number of workers in agricultural type jobs and further, that the capital investment in facilities, equipment and land represents major generators of economic activities.

Gentlemen, these statistics are particularly significant when those of us charged with public responsibility face the multitude of contemporary problems with which we are expected to deal.

The horse industry provides jobs at a time when we are seeking solutions to unemployment.

STATE REVENUE

The horse industry generates substantial revenue directly to the states at a time when you are being asked to provide federal revenue to the states.

Last week at the Southern Governors' Conference, I said that the states must commence to solve their own problems rather than look to the Congress. The states cannot solve their problems without revenue any more than the federal government can solve the problems for the states without revenue. In 1968, the total pari-mutuel revenue to all states amounted to $426.9 million. This combined with the $18.9 million in other taxes paid by race tracks brings the total tax from tracks and pari-mutuel betting to $445.8 million.

Proponents of this legislation might argue that you are indirectly subsidizing this sector of the farm economy. If that argument be true, I would only say in response that subsidizing employment, encouraging

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industry and supporting a viable revenue-producing source certainly is far more preferable than subsidizing unemployment and nonproductivity.

I would also add that migration from the rural to the urban areas is considered a major problem in this country. This proposed legislation conceivably compounds the problem.

RECREATION AND CONSERVATION OF AESTHETIC VALUES

In this period of urban sprawl and urban blight, it is gratifying to note that a substantial amount of land.....much of it within easy commuting distance of our cities.....has been set aside for horse industry activities.

Land used for horses is generally well cared for, with good cover and a minimum of erosion, In some parts of the country, such land represents the only open space and "green belts" in what would otherwise be an endless sea of houses.

It is clear to me, coming as I do from a state having an unparalleled richness in scenic attractions, that the conservation and aesthetic aspects of the horse industry have great intangible value.

It is my sincere hope that changes in the tax structure will not result in fragmenting these farms, or in drastically altering existing land-use patterns.

Many federal dollars are being invested in recreation. It is therefore highly significant that the number of horses used in recreational has increased considerably in the last decade.

Horseback riding is a major outdoor recreation activity and even without being federally subsidized has contributed to the health and vitality of our citizens.

Furthermore, Future Farmers of America, 4-H Clubs and other farm-oriented youth organizations are becoming increasingly engaged in horse projects. Thus, it is clear that the success of many of these

projects depends strongly on the availability of horses at reasonable prices.

To further demonstrate the recreational aspects of this industry, in 1967 the attendance at horse racing events alone exceeded the attendance at all other professional or amateur spectator sports.

There were 63.4 million spectators at horse races in America while only 43.4 million attended professional and college football games and 24.2 million attended all major league baseball games.

In summary, I urge you to carefully reflect on the dimensions of this important industry that I have outlined briefly today. I respectfully ask that you also consider the many other factors which either have not been measured or are by nature intangible.

Still, these factors, too, substantially increase the economic impact and other contributions of the horse industry to America.

I salute each of you for your diligent efforts to find equitable means for sharing the burden of taxation.

At the same time, however, I would urge you to take care that you do not "throw out the baby with the washwater."

HARRY J. FARNHAM
President

L. B. WALKER
Second Vice President

FRED P. DAVIS
Third Vice President

J. NEWTON BREWER, JR.
First Vice President

MRS. A. E. SMITH
Secretary-Assistant Treasurer

THE NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS

P. O. BOX 4216 LEXINGTON, KENTUCKY 40504

September 22, 1969

SUMMARY

TESTIMONY BY MR. HARRY J. FARNHAM, Chairman of the Nebraska State Racing Commissioners, and submitted as President of the National Association of State Racing Commissioners, an association founded in 1934 and comprised of all racing commissioners from all 30 states in which pari-mutuel racing is regulated and supervised by state officials.

The position of the National Association of State Racing Commissioners is one of unalterable opposition to the "farm-loss" federal tax provisions as proposed by Senator Jack Miller in Senate Bill 1560, as proposed by Senator Lee Metcalf in Senate Bill 500, and as proposed by House Bill 13270 and designated therein as Sections 211, 212, and 213.

The conclusion reached by the National Association of State Racing Commissioners after lengthy deliberation is that the aforesaid "farm-loss" proposals will discourage investment in the horse breeding industry resulting in an attrition of good horses and a sharp reduction in number of all horses bred by small breeders; that reduction in the breeding of horses will similarly affect the size and number of racing programs and thereby seriously endanger the racing industry which last year produced in direct state revenue a sum exceeding 426 million dollars; that in addition to the direct state revenue derived from racing, collection of federal, state and local taxes presently generated by the horse industry which employs more than 158 thousand persons with a payroll exceeding one billion dollars also will be curtailed.

It is urged that Sections 211, 212, and 213, of H.R. 13270 be deleted on the basis that fulfillment of the federal government's need for additional revenue should not jeopardize the equine industry's source of funds for our states' pressing needs.

HARRY J. FARNHAM
President

L. B. WALKER
Second Vice President

FRED P. DAVIS
Third Vice President

J. NEWTON BREWER, JR.
First Vice President

MRS. A. I. SMITH
Secretary-Assistant Treasurer

THE NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS

P. O. BOX 4216 LEXINGTON, KENTUCKY 40504

September 22, 1969

The Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate
2227 New Senate Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

My appearance before the distinguished members of this Committee is on behalf of the National Association of State Racing Commissioners of which I am President.

I am Chairman of the Nebraska State Racing Commission, an administrative agency charged with the statutory responsibility of regulating and supervising horse racing at the six tracks in Nebraska. I was appointed by Governor Norbert T. Tiemann.

The National Association of State Racing Commissioners was formed in 1934 and its membership comprises all racing commissioners from the 30 states in which pari-mutuel racing is conducted, namely, Arizona, Arkansas, Delaware, Idaho, Illinois, Louisiana, Nebraska, New Mexico, California, Colorado, Florida, Kentucky, Maine, Maryland, Massachusetts, Michigan, Montana, Nevada, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Vermont, Washington, West Virginia, and Wyoming. Other Association Officials appearing with me are: Mr. J. Newton Brewer, Chairman of the Maryland State Racing Commission, and Mr. John A. Bell, Kentucky State Racing Commissioner. Mr. Brewer is presently First Vice-President of the Association and will succeed me as

President next year. Mr. Bell is Chairman of our Public Relations Committee, and one of his responsibilities is working on a comprehensive plan for a national economic study of racing.

We have been directed to submit for your consideration the position of the National Association of State Racing Commissioners as to the changes in farm tax accounting proposals together with the facts and reasons from which this conclusion is drawn. Our position is presented today after lengthy deliberation and study.

The position of our Association is one of unalterable opposition to the farm tax accounting provisions as proposed by Senator Jack Miller in Senate Bill 1560, as proposed by Senator Lee Metcalf in Senate Bill 500, and as proposed by House Bill 13270 and designated therein as Sections 211, 212, and 213.

While our opposition to these proposals may be similar to others presented to this Committee, it differs in one significant way. The position of the state racing commissioners is not a personal one. It was not determined by self-interest, nor by concern for a racing commissioner's salary. Salaries in those states which provide for remuneration are nominal and the majority of racing commissioners serve without pay. All racing commissioners serve at the pleasure of the various State Governors and are charged with the responsibility of regulating and supervising racing so as to maintain public confidence in the sport. Each racing commission must report annually to the legislature giving a detailed account of state tax revenue gained from pari-mutuel racing. This is a most important part of the commissioner's responsibility.

All racing officials are seriously concerned with the possible side

effects of the proposed farm tax changes, consequences perhaps not envisioned by proponents of these changes, but which we as racing officials fear will prove extremely detrimental to racing and which can reduce significantly state tax revenue derived from racing.

As a part of our statement, we would like to include Statistical Reports on Horse Racing in the United States for the Year 1968, and as reflected in that document, Table No. 1, the direct state tax revenue derived from racing last year amounted to more than 426 million dollars. As shown on Table No. 5, the direct state tax revenue derived from racing increases each year as racing increases and we expect the direct state tax revenue of more than 426 million dollars in 1968 to approach 500 million dollars this year.

These are whole tax dollars, as distinguished from those tax dollars which require 45 cents to collect. This racing revenue costs the states nothing to collect. The racing commissions collect the license fees while the race tracks collect the tax revenue from admissions and pari-mutuel handle in such amounts as shown on Table No. 2 in the reports, and this sum is paid over directly to the states.

This state revenue comes from a self-imposed tax, and a state tax which cannot be deducted by the taxpayer against any federal taxes. This is an important source of state tax revenue which provides more than 155 million dollars for schools in New York, more than 57 million dollars for roads in California, and more than 40 million dollars for county projects in Illinois. These are significant budgetary accounts for important services provided by tax revenue from racing.

At this very moment, states, counties, and cities are demanding more federal funds to meet critical local needs. You well know that whatever

the states lose in decreased tax revenue will ultimately have to be made up in federal funds. How much federal tax revenue is expected to be gained from these new farm tax accounting provisions? The House Ways and Means Committee report, on page 71, indicates that the "farm-loss" provisions will produce an estimated five million dollars in 1971. If state tax revenue drops only 20 percent, the states would lose 100 million dollars.

Mention has been made here only of the direct state tax revenue derived from racing, a sum expected to approach 500 million dollars this year. This is the readily accountable tax revenue from racing which we report each year as turned over directly to state treasuries from race track operation. Yet this is only a small portion of the federal, state, and local tax revenue generated by the racing industry. The National Association of State Racing Commissioners this year adopted a comprehensive plan for a national economic study of racing. This plan is being implemented under the direction of Mr. Bell' Committee, and the economic analysis of the data now being collected is expected to be completed next year.

Surveys preliminary to this comprehensive study indicate that the horse industry in the United States provides employment for more than 158 thousand persons with a payroll exceeding one billion dollars. This is an industry with fixed assets of one billion 261 million dollars in land, one billion 115 million dollars in horses, 621 million dollars in equipment, and 602 million dollars in race track property.

This is an industry which we as racing commissioners fear will be critically affected by the proposed changes in farm tax accounting. Proponents of these measures assert that the EDA, recaptured depreciation,

longer holding period to receive capital gains and the $25,000 loss in three of five years, are designed to gain five million dollars in federal taxes from 100 rich people. These provisions, however, will affect not just 100 rich people, but the incomes of 158 thousand grooms, harness drivers, ranch hands, insurance men, Western clothing manufacturers, blacksmiths, hay growers, mutuel clerks, harness makers and parking lot attendants.

Racing and direct state tax revenue from racing depend to a large extent on the good horse. People come out to see the stars. The good horse is a rarity. Statistics compiled by The Blood Horse magazine last year showed that 43,715 Thoroughbreds raced and only 729 of these won a stakes race. That is one good horse out of 60. Statistics compiled by the American Petroleum Institute show that only one out of nine drilled wells produces oil and it is generally conceded that a tax incentive is essential for a man to challenge nine to one odds. Whatever tax incentive there may be for a horse breeder to challenge 60 to one odds is removed by these proposed changes in farm tax accounting.

The proposals will discourage the extremely successful businessman and preclude the moderately successful businessman from investing risk capital in the horse breeding industry. Breeding the good horse today requires a substantial investment in breeding stock and far more than five years of possible losses before a profit can be realized in that one good horse out of 60. However, the vast majority of horses are not produced by the large breeding operations, but by small breeders with four or five broodmares. Statistics compiled by Triangle Publications show that the 43,715 Thoroughbreds which raced last year were bred by 14,369 different

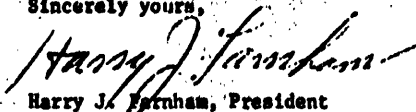
persons, an average of three horses per breeder.

Removal of tax incentives from the horse breeding industry will discourage investment by the big breeder, and thereby can seriously curtail the production of good horses. These farm-loss proposals, moreover, can preclude investment by thousands of small breeders, and thereby critically reduce the overall number of horses needed to fill our race programs.

The National Association of State Racing Commissioners, therefore, desires to express its opposition to these proposals in the strongest possible manner. While the proposals are designed to gain five million dollars from 100 rich men, they serve as a deterrent to the more than 14 thousand other breeders who produce the horses for an industry that employs more than 158 thousand persons with a payroll exceeding one billion dollars, an industry that last year produced in direct state tax revenue more than 426 million dollars.

Our Association and all racing officials, on behalf of the industry, strongly urge this Committee to delete sections 211, 212, and 213, of H.R. 13270, that are so damaging to an industry making such a substantial contribution to state revenues — which in the case of 1969-70 are already committed. Although we are cognizant of and sympathetic with the federal government's need for additional revenue, it is our considered judgment and strong feeling that the fulfilling of this requirement should not jeopardize the equine industry's important source of funds for our states' many pressing needs.

Sincerely yours,



Harry J. Farnham, President

STATEMENT OF HERBERT A. FOGEL, GENERAL COUNSEL FOR THE PENNSYLVANIA HARNESS RACING COMMISSION, REPRESENTING THE COMMONWEALTH OF PENNSYLVANIA

IN CONNECTION WITH THE COMMONWEALTH POSITION ON HR13270 AND THE PROPOSED AMENDMENT TO SECTION 270 OF THE IRC OF 1954

My name is Herbert A. Fogel and I am General Counsel for the Pennsylvania Harness Racing Commission. I have been authorized by the Governor to appear before the Senate Finance Committee on behalf of the Commonwealth of Pennsylvania at these hearings.

May I say, in the first instance, that the Governor and the other administration officials of the Commonwealth of Pennsylvania are most grateful to the Committee for affording me this opportunity to appear because of the grave economic consequences that would follow if the changes proposed by H.R. 13270 as an amendment to §270 were adopted in their present form.

The changes proposed by H.R. 13270 as an amendment to §270 wherein "Items attributable to an activity shall be allowed only to the extent of the gross income from such activity unless such activity is carried on with a reasonable expectation of realizing a profit" could rapidly result in drastic curtailment of Standardbred and Thoroughbred horse racing in the Commonwealth of Pennsylvania, with a resultant loss of state revenues, as well as employment to many thousands in the Commonwealth whose economic livelihood depends on Standardbred and Thoroughbred racing and its related industries.

In 1968, the Commonwealth of Pennsylvania received in direct taxes from pari-mutuel harness racing alone a sum in excess of seven million four hundred thousand dollars. Pari-mutuel thoroughbred racing in Pennsylvania commenced for the first time in 1969. It is conservatively es-

timated that harness racing will yield in excess of eight million dollars in revenue in 1969, and thoroughbred racing another five million, making a total of thirteen million dollars as direct taxes from this source.

In addition, the City of Philadelphia has a dire need for taxes for education, a need that plagues so many other major cities in the country. Philadelphia received almost two million dollars in direct taxes from pari-mutuel wagering for its public schools in 1968. In 1969, it is estimated that this figure, through the combined revenues of harness and thoroughbred racing, will approximate three and one-half million dollars.

In areas of the State other than Philadelphia in which harness racing tracks are located, approximately a million dollars in taxes were raised in 1968 for smaller communities needing funds to improve their sewage and water disposal plants. These sums will also be substantially increased in 1969.

The figures cited do not take into account other substantial revenues which the Commonwealth derives from sales taxes on food and other items sold both on and off the tracks in connection with the conduct of the pari-mutuel racing industries.

Pennsylvania, in this connection, is but representative of the thirty states that have pari-mutuel racing. For the year 1968 alone, the tax revenues from racing to these states were in excess of $426,800,000. The proposed changes will seriously affect, if not destroy this source of revenue, at a time when this Committee is well aware of the monumental problems confronting the states in their efforts to raise the necessary tax revenues in order to continue to furnish necessary services.

Quite apart from the loss of tax revenues, however, the impact upon the economy of the Commonwealth would be even more devastating.

In Pennsylvania alone there is a capital investment in racing plants

of approximately fifty million dollars. All facets of the horse industry in Pennsylvania, including the land in use for raising and breeding horses, represent an investment that is well in excess of one hundred million dollars. The payroll at the tracks alone for grooms, trainers, waiters, maintenance men and others who find gainful and useful employment through the operation of pari-mutuel racing in Pennsylvania is in excess of ten million dollars annually. The salaries of all others who are employed in all facets of the horse industry, including the feed and breeding industries, brings the annual payroll to well in excess of fifty million dollars. These figures projected for the thirty states would indeed demonstrate the very substantial contribution to the overall economy made by horse racing and related industries.

The administration in Pennsylvania is mindful of the purposes behind the Tax Reform Act of 1969 and, indeed, the Commonwealth not only realizes, but supports the need for tax reform in many areas.

The concern, however, is that in attempting to bring about needed reforms in certain areas, the wording of §270 is such that it could result in bringing about a result which we know is not the intent of the drafters of this legislation: namely, the virtual destruction of the horse racing industry.

§213 of H.R. 13270,* in particular, which sets forth the general rule without reference to dollar limits could be interpreted to eliminate the thousands of persons who own horses on an extremely modest scale and whose gross income from this activity in the years in which they do not have good winning horses often does not exceed three to four thousand dollars per year, while their expenses are in excess of that amount.

According to the thoroughbred record on distribution of earnings for all 1967 horses that started in races, there were 28,743 thoroughbreds with winnings of $3,000.00 or less, and the average winnings of this

*(§213 contains the amendments proposed to §270 of the IRC of 1954)

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group were $802.00 for each winning horse. This includes over 70% of the horses starting and does not include the number of horses trained on which expenditures were made that were not even able to enter races due to lameness or sickness.

In harness racing, 20,473 horses earned less than $3,000.00 per horse, with the average earnings of this group totalling only $863.00 per horse. Again, this number represents 75% of the horses that actually started, and does not include horses which were trained and for reasons cited were unable to enter races.

Horse racing, by its very nature, is a hazardous undertaking due to sickness, lameness and other hazards which are unpredictable. §213 of H.R. 13270, as written, could drive the bulk of theowners out of the business since the bulk of the owners are, indeed, the small owners. The probable result would be that there would not be enough horses to fill the races, thus depriving the Commonwealth of this source of revenue collected in 1968 as the result of the activity of 1,750,000 patrons who wagered a total in excess of 126 million dollars. Indeed, the effect would be the same upon all thirty states, in which 65,460,000 patrons in 1968 wagered in excess of $5,226,000,000.00, to bring about the tax yield of almost one-half billion dollars.

Although the small owners incur losses frequently until they are fortunate enough to develop a horse or horses that can recoup these losses, the over-all picture, including the revenues obtained by the states, is not one of a "loss" industry. In addition to the approximately one-half billion dollars in state taxes, about one-third of a billion dollars in purses will be paid to the owners of competing horses in 1969.

Assistant Secretary Cohen, on page 29 of his statement before this Committee, states:

"The Administration urges the adoption of this proposal as an effective means of dealing with cases where the tax loss are being used to subsidize the hobbies of wealthy taxpayers."

We believe the objective can be attained without destroying the entire industry with the concomitant ill effects on thousands of small taxpayers and thousands of other persons whose livelihood depends on the bus- of horse racing.

Specifically, we believe that there are several approaches which we would respectfully submit for consideration by the Committee that can achieve the desired result of eliminating the abuses and at the same time not destroy the horse racing industry itself.

First, the proposal that the holding period for horses be at least 365 days after such animal normally would have first been used for its intended purpose before capital gains treatment will be afforded is certainly one that we heartily endorse. We believe that this would go far toward eliminating the abuses of some who are not interested in the sport or the industry, but merely interested in a tax shelter.

Second, we submit that depreciation rules akin to those set forth in §1245 of the Internal Revenue Code be adopted, as proposed in H.R. 13270, with respect to the sale of horses and other livestock. We believe that it would be equitable for those in the horse business to have the horses treated in the same manner a businessman has personal property, such as machinery, treated upon the sale of that property. Specifically, to the extent that depreciation would be taken (whether straight line or accelerated), upon the sale of the animal, the tax treatment would be as follows: if the price is in excess of the adjusted basis of the animal, the amount in excess of the adjusted basis which is realized that is equal to depreciation taken should be taxed as ordinary income with capital gains treatment being restricted to the balance received. The enactment of the changes to §1245 of the Internal Revenue Code which includes live-

stock would be sufficient to curb any abuses presently in the industry. As such, §211 of the House Reform Bill relating to the denial of capital gains when there exists a surplus in an excess depreciation account, should be deleted. In short, we fell that there is no need to place a heavier burden on the horse industry than is presently placed on other businessmen.

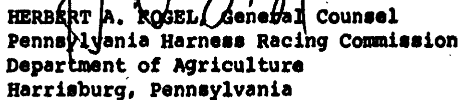
Third, we submit that the proposed changes to §270 of the Internal Revenue Code be entirely deleted.

We believe that such legislative changes, rather than the changes proposed to §270, would achieve the result of correcting the abuses and, at the same time would permit the thousands of legitimate and bona fide persons who own and breed horses to remain in this industry.

In enacting these changes, the States would not be losing a vital source of revenue and the thousands of persons employed in this industry would continue to earn their livelihood in this manner.

Again, may I thank the Committee for the opportunity that was afforded me on behalf of the Commonwealth to submit these views.

Respectfully submitted,



HERBERT A. FOGEL, General Counsel
Pennsylvania Harness Racing Commission
Department of Agriculture
Harrisburg, Pennsylvania

National Livestock Tax Committee

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SECRETARY
C. W. McMillan
Denver, Colorado

ATTORNEYS:
Holland & Hart
500 Equitable Building
Denver, Colorado 80202

SUMMARY OF STATEMENT OF CLAUDE M. MAER, JR. ON BEHALF OF NATIONAL LIVESTOCK TAX COMMITTEE TO THE SENATE FINANCE COMMITTEE WITH RESPECT TO TAX REFORM PROPOSALS AFFECTING LIVESTOCK TAXATION

September 22, 1969

The National Livestock Tax Committee feels that certain provisions of H. R. 13270, namely those dealing with an Excess Deductions Account (EDA), a Hobby Loss Presumption, a Limit on Tax Preferences (LTP) and an Allocation of Deductions, are unnecessary and are contrary to the basic objectives of a sound and equitable tax system. These unneeded provisions of H. R. 13270 unfairly discriminate between farmers and ranchers based upon accounting systems used and the size of losses sustained; impose restrictions on capital gains claimed by persons only in agriculture and classify only certain losses from farming, but not from any other business, as "tax preferences"; and make compliance with and enforcement of these unneeded provisions unworkable and in some instances practically impossible.

The Tax Committee is of the opinion that fair and equitable tax treatment of ranch and farm businesses can be

(LIST OF SPONSORS ON REVERSE SIDE)

achieved by adoption of the proposals made by the Tax Committee which were included in the House bill (in somewhat modified form). These proposals will eliminate the relatively small amount of tax profiteering and will not substantially harm the industry in that they are simple and easy to apply and will not require complicated cost accounting techniques. Furthermore, these proposals of the Tax Committee will not have the effect of: discouraging farmers and ranchers from diversifying into non-farm businesses and investments; isolating agriculture from the rest of the nation's economy; impeding needed agricultural programs; stemming the flow of needed new blood and capital into the industry; and causing meat price increases, as would undoubtedly be the case if the unneeded farm loss provisions of H. R. 13270 were enacted.

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STATEMENT BY CLAUDE M. MAER, JR.
ON BEHALF OF THE
NATIONAL LIVESTOCK TAX COMMITTEE
WITH RESPECT TO TAX REFORM PROPOSALS
AFFECTING LIVESTOCK TAXATION

September 22, 1969

I. INTRODUCTION

My name is Claude M. Maer, Jr. I am a partner of the law firm of Holland & Hart, Denver, Colorado, which is and has been counsel for the National Livestock Tax Committee for many years. The National Livestock Tax Committee is a nonprofit corporation organized and operating for the purpose of maintaining and assuring equity and equality in the field of federal income, gift and estate taxation for the entire livestock industry, not only beef cattle, but also sheep, horse and dairy interests. The Tax Committee was first formed in 1942 and has been active continuously since then. The Committee is sponsored by 6 national, 11 breed and 45 state associations representing roughly 300,000 individual farmers and ranchers throughout the fifty states. The following is a list of the Tax Committee's sponsors:

NATIONAL AND BREED SPONSORING ORGANIZATIONS

American Angus Association
American Brahman Breeders Association
American Guernsey Cattle Club
American Hereford Association
American International Charolais Association
American Jersey Cattle Club
American National Cattlemen's Association
American Polled Hereford Association
American Quarter Horse Association
American Shorthorn Association

Holstein-Friesian Association of America
International Brangus Breeders Association
National Society of Live Stock Records Association
National Wool Growers' Association
Pony of the Americas Club, Inc.
Santa Gertrudis Breeders International
Thoroughbred Owners and Breeders Association

STATE SPONSORING ORGANIZATIONS

Alabama Cattlemen's Association
Arizona Cattle Feeders' Association
Arizona Cattle Growers' Association
Arizona Wool Growers' Association
Arkansas Cattlemen's Association
California Cattle Feeders' Association
California Cattlemen's Association
California Wool Growers' Association
Colorado Cattlemen's Association
Colorado Wool Growers' Association
Florida Cattlemen's Association
Georgia Livestock Association
Hawaii Cattlemen's Council
Idaho Cattlemen's Association
Idaho Wool Growers' Association
Kansas Livestock Association
Louisiana Cattlemen's Association
Maryland Beef Cattle Producers, Inc.
Mississippi Cattlemen's Association
Missouri Cattlemen's Association
Montana Stockgrowers' Association
Montana Wool Growers' Association
Nebraska Stock Growers' Association
Nevada State Cattle Association
Nevada Wool Growers' Association
New Mexico Cattle Growers' Association
New Mexico Wool Growers' Association
New York Beef Cattlemen's Association
North Carolina Cattlemen's Association
North Dakota Stockmen's Association
Oklahoma Cattlemen's Association
Oregon Cattlemen's Association
Oregon Sheep Growers' Association
South Dakota Stock Growers' Association
Tennessee Livestock Association
Texas and Southwestern Cattle Raisers Association
Texas Sheep and Goat Raisers' Association
Utah Cattlemen's Association
Utah Wool Growers' Association
Virginia Beef Cattlemen's Association

Washington Cattlemen's Association
Washington Wool Growers' Association
Western South Dakota Sheep Growers' Association
Wyoming Stock Growers' Association
Wyoming Wool Growers' Association

II. PROPOSALS OF NATIONAL LIVESTOCK TAX COMMITTEE

Earlier this year when hearings on various tax reform proposals were held by the House Ways and Means Committee, the National Livestock Tax Committee presented a statement and testimony on the subject of proposed changes in the federal income tax laws affecting livestock and other agricultural operations. At the request of members of the House Ways and Means Committee, the National Livestock Tax Committee agreed to work with the staff of the Ways and Means Committee in proposing several changes in the livestock tax laws which would eliminate profiteering in the industry which is caused by a few persons who enter the business on an in-and-out basis with the only intention being of making a tax profit as opposed to an economic profit.

After an in-depth study of this situation, the National Livestock Tax Committee submitted certain proposals which would help eliminate tax profit schemes in agricultural operations while at the same time provide fair and equitable tax treatment for the whole agricultural industry. These proposals were: (1) apply the depreciation recapture rules of section 1245 of the Internal Revenue Code to purchased livestock used for draft, breeding, dairy or racing purposes; (2) extend the holding period

of cattle and horses from 12 months to 24 months in order to qualify for capital gains treatment under section 1231 of the Internal Revenue Code;* (3) clarify that male calves or steers cannot be traded tax-free for female calves or cows; (4) require a taxpayer to prove the purpose for which he held livestock in addition to proving the length of time the livestock were held to qualify for capital gains; and (5) establish a sliding scale recapture of land improvement expenses when farm or ranch land is sold within ten years after its acquisition.

III. CERTAIN PROVISIONS OF H. R. 13270 (TAX REFORM ACT OF 1969) PERTAINING TO FARM LOSSES ARE NOT NECESSARY AND ARE CONTRARY TO OBJECTIVES OF AN EQUITABLE AND SOUND TAX SYSTEM

Following hearings on proposed tax reform, the House Ways and Means Committee reported to the House of Representatives its recommendations on tax reform, which recommendations were subsequently passed by the House as H. R. 13270. This bill contained a number of the suggested proposals of the National Livestock Tax Committee, although some of these proposals had been modified. However, H. R. 13270 included several additional provisions pertaining to livestock taxation which went considerably further than the proposals offered by the National Livestock Tax

* Exempted from this increased holding period requirement would be animals subject to involuntary conversion due to drought or disease, since the premature disposition of such animals results from circumstances beyond the taxpayer's control.

Committee. These additional provisions, all of which relate to farm losses, include an Excess Deductions Account (EDA), a Hobby Loss Presumption, a Limit on Tax Preferences (LTP), and an Allocation of Deductions. The Tax Committee feels that these additional provisions (hereinafter sometimes referred to as "unneeded provisions") go much too far, are not necessary to prevent tax profiteering, and are contrary to the basic tenets and objectives of an equitable and sound tax system.

A. Objectional Provisions Unnecessary

These unneeded provisions of H. R. 13270 are not necessary for purposes of preventing tax-profiteering, result in an "overkill" approach, would create complexity and confusion throughout the industry, and would cause changes in the overall economics of the livestock industry, all of which would cause serious harm to the entire livestock industry. Unlike the proposals of the National Livestock Tax Committee which single out and clamp down solely on the few persons engaged in tax profiteering in the industry and which provide fair and equitable tax treatment for the whole industry, these unneeded provisions of H. R. 13270 would apply on a broad scale to all livestock operators. In short, these unneeded provisions would "burn down the barn to catch a few rats."

B. Reason these Provisions Objectionable

It is the position of the National Livestock Tax Committee that the essential and basic objectives of an

equitable and sound tax system are: (1) to raise revenue; (2) to treat all taxpayers engaged in the same business fair and equitably; (3) to treat all taxpayers in the entire business community fair and equitably; and (4) to provide for efficient and workable compliance and enforcement. The Tax Committee feels that these unneeded provisions of H. R. 13270 are contrary to all of these essential rules.

1. <u>Not Intended to Raise Revenue</u>

In the so-called "farm loss provisions" of H. R. 13270, which encompass EDA, Hobby Loss Presumption, depreciation recapture for livestock and increased holding period requirements for livestock, the House Ways and Means Committee Report estimates that all of these provisions would increase revenue by the relatively insignificant sum of $5 million in 1971.

Back in 1963, when the Treasury Department first proposed EDA, it was estimated that EDA alone would yield only $5 million per year in tax revenue. But it is now estimated, nine years later, that all of these "farm loss provisions" would increase revenues by just $5 million. This statement by itself refutes the claim of increasing tax profiteering that allegedly has caused a great loss of tax revenue and evidences the desire to extend these "farm loss provisions" across the board to all farmers and ranchers and not restrict tax reform to eliminating tax profiteering as do the proposals of the National Livestock Tax Committee. Yet, the announced intention of these "farm loss

provisions" is to stop the practice caused by "some high-income taxpayers who carry on limited farming activities as a sideline to obtain a tax loss which is then deducted from their high-bracket, non-farm income".

2. Treats Farm and Ranch Taxpayers Unfairly as Between Themselves

a. EDA

(1) Corporations, Trusts and Estates Hardest Hit

As written, EDA would apply to all farmers and ranchers on the cash method or using presently acceptable accrual methods of accounting* who incurred farm losses or who acquired certain farm property already subject to previously accumulated farm losses. However, no additions would have to be made to EDA by taxpayers operating as individuals unless non-farm income exceeded $50,000 and only to the extent farm losses were in excess of $25,000. All farm losses incurred by other taxpayers (i.e. corporations, trusts and estates) would generally be added to EDA without these limitations.

Thus, hardest hit by these provisions of EDA would be the numerous small and medium-sized family-owned corporations, trusts and estates engaged in farming or ranching which have even small amounts of non-farm income. Such taxpayers would be unduly penalized just because they received non-farm income, such as rentals, royalties, or other business income, and as other businesses, combine all income and losses from whatever source earned in computing their taxable income.

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* See discussion beginning on p. 16.

(2) Imposition of Burdensome Record Keeping Requirements

Furthermore, farmers and ranchers who remained on the cash basis or used presently acceptable accrual methods would be required to compute losses each year and maintain a separate EDA. To all of these operators, this would be very troublesome and in many cases virtually impossible because of the complexities involved. Even to those legitimate operators who have access to reliable outside record keeping and tax assistance and can afford to pay for such services, this would impose an additional cost and further reduce their already small margin of profit.

In 1952, the Secretary of the Treasury presented to the Congress a proposal* to modify the cash basis so as to require capitalization of all costs of raising breeding herd livestock. At that time, the Tax Committee pointed out the practical necessity for simple accounting methods and Congress agreed by failing to act on the Treasury's contention. There has been no substantial change in conditions which would require or warrant a different approach today.

(3) Capital Gains Denied

In addition to discrimination based upon what form of accounting system was employed and in what form the livestock

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* Special letter from the Secretary of Treasury to the Chairman of the Senate Finance Committee dated June 27, 1952, 98 Cong. Rec. Pt. 6, p. 8207, 1952 CCH Fed. Tax Rep. ¶ 6239.

business was operated, EDA would also categorize individual farmers or ranchers as being "undesirable" by limiting capital gains on the sale of their farm property if they were in a certain non-farm income bracket and sustained farm losses over $25,000. Singling out such farmers and ranchers for this type of treatment even though they are legitimate operators seems most unfair.

(4) Full Deductibility of Interest and Property Taxes Denied

EDA would further and unjustly injure those taxpayers who have borrowed money to obtain working capital for the operation or purchase of farms or ranches, since the interest paid on these loans would increase farm losses. Taxpayers in debt would be discriminated against and persons would be discouraged from entering the industry on a legitimate basis by acquiring farms or ranches subject to a mortgage. Moreover, higher and higher property taxes would also swell the EDA and thus reduce their full deductibility by reason of the required offset of EDA against capital gains.

(5) Sales of Farm and Ranch Property Hit - Conservation Discouraged

In addition to restricting capital gains on the sale of livestock and other farm assets, EDA would tax gain realized on the sale or exchange of farm and ranch land at ordinary income rates, instead of at capital gains rates as under present law, to the extent of land clearing and soil and water conservation

expenses deducted during the current taxable year plus the four previous taxable years. As with other provisions of EDA, this would only apply to farmers and ranchers using the cash basis or presently acceptable accrual methods of accounting. This provision not only represents bad economics and bad agricultural policy, but it also would discourage needed and continuing conservation projects which are so vital to the industry. The adverse repercussions such provision could have on the reduction or termination of needed conservation projects would also be felt by other businesses connected with the promotion and operation of such projects and by the consuming public dependent on agricultural products.

b. Hobby Loss Presumption

(1) Would Disallow All Farm Losses to Certain Farmers and Ranchers

If farm losses exceeded $25,000 for any three of five consecutive years, even a legitimate farmer or rancher who has been in the business all his life would be presumed to be a "hobby farmer" and all his losses could be disallowed under the Hobby Loss Presumption provision of H. R. 13270. This provision would apply to all taxpayers, whether doing business as individuals or in corporate form.

The cyclical nature of farming and ranching, the adverse effect of climate and weather, sporadic and unstable market prices, and continually rising production costs could

easily result in farm losses incurred by many legitimate operators exceeding $25,000 for any three of five years. No exceptions or exclusions would be made for death or casualty losses or certain fixed expenses such as taxes and interest.

Thus, a farmer or rancher who sustained losses in excess of $25,000 for any three of five years because of drought, blizzards, falling livestock prices, and increasing operational costs could have <u>all</u> his losses disallowed while his neighbor who sold his livestock at a different time or escaped the full blow of adverse weather conditions and had losses of $24,999 for this period would not be subject to the disallowance of such losses under this provision.

(2) <u>Could Cause Lumping of Income Tax</u>

Farmers and ranchers whose farm losses were disallowed under this Hobby Loss Presumption could find their income taxes greatly increased in one year as a result of disallowance of farm losses in prior years. As previously explained, this could apply to and cause a terrific hardship to a farmer or rancher who because of factors beyond his control, such as adverse weather conditions, increasing costs or low market prices, had losses in excess of $25,000, while his neighbor with $24,999 of losses would not be subject to such disallowance. Under these circumstances, the farmer or rancher with the disallowed losses could discover that the increased income taxes resulting from the disallowance of such losses in prior years greatly increased his taxes in one

particular year. Securing the necessary funds to pay these additional taxes could present a very serious problem to such farmer or rancher.

(3) To Rebut Presumption Would be Time-Consuming and Expensive

To try to rebut the presumption that the farm or ranch was not operated with a profit motive would be both time-consuming and expensive and could even be a recurring event. Furthermore, the uncertainty caused by this provision whereby a farmer or rancher may be treated as a "hobby operator" one year and all his farm losses denied, and as a "legitimate" operator the next year, would be very disruptive and create great uncertainty throughout the whole industry. Because of changing and variable conditions previously noted, a farmer or rancher might be presumed to be a "hobby operator" and all his losses disallowed necessitating lengthy and costly protests or litigation, whereas his neighbor whose losses were just a few dollars less would escape this presumption and not have to go to the added expense of contesting the presumption.

c. LTP and Allocation of Deductions

(1) Would Classify Farm Losses of Some Taxpayers as "Tax Preferences"

Farmers and ranchers (individuals, trusts and estates) on the cash basis or using presently acceptable accrual methods of accounting* would generally be subject to additional tax liability and/or to a reduction of personal itemized deductions

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* See discussion beginning on p. 16.

if certain of their farm losses exceeded $10,000 under the LTP and Allocation of Deductions provisions. In such cases, farm losses would be termed "tax preferences". This would result in different tax treatment for farmers and ranchers based upon the system of accounting they used. In addition, there would be further discrimination between farmers and ranchers on the cash basis or using presently acceptable accrual methods who had certain farm losses under $10,000 and those who had farm losses exceeding this amount.

(2) Would Adversely Affect Some Farmers and Ranchers but not Others

Farmers and ranchers would be caught in an ignominious vise under these provisions in that capital gains realized on the sale of farm assets would not be considered in determining farm loss "tax preferences" although the deductible portion of such capital gain would be treated as another "tax preference" resulting in increased income taxes and restricting itemized personal deductions. Also, death and casualty losses and fixed operational expenses such as interest and taxes would not be deleted from the formula in computing farm losses. In application this would mean that, as under EDA and the Hobby Loss Presumption provisions, farmers and ranchers who fell on hard times or sold their livestock when prices were low would be penalized while neighboring farmers and ranchers who were lucky and escaped these catastrophies would not be subject to additional tax or to a reduction of their itemized personal deductions.

3. Singles Out Farmers and Ranchers for More Adverse Treatment than Taxpayers in Other Businesses

a. EDA

(1) Would Restrict Capital Gains on Livestock and Farm Property

The principle and provisions of EDA - restricting capital gains treatment of livestock and other farm property - are harmful to most farming and ranching operations, large and small, and would be a most serious blow to the whole livestock industry. This EDA provision constitutes discrimination against farming and ranching. No other businesses are singled out in like manner for such treatment. Yet, livestock are still selling at below parity prices.

(2) Would Recapture Certain Conservation Expenses at Ordinary Income Rates When Farm or Ranch Land Sold

Under EDA, gain realized on the sale of farm or ranch land would be subject to taxation at ordinary income rates, instead of at capital gains rates as under present law, to the extent of land clearing and soil and water conservation expenses deducted in the 5 years prior to the sale. Yet, no other business is subject to such restrictions on the sale of its land used in business operations. Moreover, the Congressional policy of providing farmers or ranchers under present law with the right to deduct these expenses in order to foster and encourage conservation projects would be abrogated.

b. Hobby Loss Presumption

Would Appear to put "Hobby" Label on Agricultural Operations

Including the Hobby Loss Presumption section under the "farm loss provisions" of H. R. 13270 appears to be an attempt to place the tag of "hobby" on the agricultural industry and subject it to unreasonable and deleterious tax provisions. Yet, agriculture today is big business and remains near the top in size of all businesses in the country.* More importantly, it is one of the most vital of our nation's industries, for a country without adequate supplies of food and fiber would soon cease to exist. In this regard, it should also be recognized that agricultural operations require vast amounts of capital and are not entered into by the great majority of taxpayers just to lose money, as this provision of H. R. 13270 erroneously implies.

c. LTP and Allocation of Deductions

Would Unjustly Single out Farm Losses as "Tax Preferences"

The Limit on Tax Preferences (LTP) and Allocation of Deductions provisions of H. R. 13270 unfairly label certain farm losses as "tax preferences". Yet, losses from no other business are termed or treated as "tax preferences" under these provisions of H. R. 13270.

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* See Food Costs - Farm Prices, Committee on Agriculture House of Representatives (90th Congress, 1st Session July, 1967) at 15.

Farming and ranching are one of the highest risk businesses in the country. The vagaries of weather, an unstable and sometimes non-existent labor force, and unsteady market prices make the farming and ranching business subject to elements beyond its control not experienced by any other industry. Under these conditions, and considering the absolute dependency of the nation's health on an adequate supply of food and fiber, it is not only dangerous tax policy but also precipitous agricultural and economic policy to term farm losses as "tax preferences" when all but a very few persons in the country are legitimate operators.

d. Farming and Ranching Subject to Specific and General Provisions

Farming and ranching, with possibly only one or two exceptions, is the only business that is singled out for both special and general tax treatment under H. R. 13270. The so-called "farm loss" provisions of H. R. 13270 apply specifically to all agricultural operations. Yet, certain farm losses are also treated as "tax preferences" under LTP and Allocation of Deductions. The singling out of agriculture for this sort of dual treatment appears to be an unreasonable discrimination against farming and ranching.

4. Compliance and Enforcement will be Neither Efficient nor Workable

a. New and Difficult Accounting System Prescribed for Livestock Industry

(1) Livestock Operators Discouraged to Use Cash Basis and Presently Acceptable Accrual Accounting Systems

Under EDA, it is provided that farmers and ranchers

who use a "proper" accrual method of accounting (i.e. "by using inventories and by charging to capital account all expenditures chargeable to capital account" which can under present law be either deducted currently or capitalized) would in general not be subject to the provisions of maintaining an excess deductions account under EDA. This could have the tendency of forcing many farmers and ranchers on to this impossibly complex "proper" accrual system. In any event, this would pose a Hobson's choice to farmers and ranchers who would have to decide between maintaining a complex accounting of farm losses by establishing an excess deductions account and being subject to the restrictions spelled out under EDA or employing the even more complex "proper" accrual system and not being permitted to deduct certain expenses as under present law. Similarly, under the LTP and Allocation of Deductions provisions of H. R. 13270, all farmers and ranchers operating in other than corporate form and who in general incur farm losses in excess of $10,000 would be forced to use a "proper" accrual system, since if they do not use such accrual system they would be required to keep two sets of accounting records - one on their present method and one on the "proper" accrual method.

Under this "proper" accrual system, it would appear that farmers and ranchers would have to use inventory methods based upon actual costs of raising farm livestock and produce instead of on amounts "which reasonably account for the normal costs incurred in producing the animals" under the unit livestock price method of the present Treasury Regulations. This would mean that costs of raising crops and livestock would have to be separately computed and would not be deductible until such crops or livestock were sold.

Furthermore, the effect of such system would be to abolish in one fell swoop and arbitrarily to deny to farmers and ranchers the important and heretofore Congressionally recognized provisions of the Internal Revenue Code dealing with the deductibility of soil and water conservation expenditures (section 175), fertilizer costs (section 180), and land clearing expenses (section 182).

Most alarming of all is the fact that for the first time in the history of federal taxation of agriculture, Congress has attacked the cash basis method of accounting and also apparently the use of presently acceptable unit livestock price inventory methods, by the suggestion in the House Ways and Means Committee Report that these are not "proper accounting rules". This represents a marked and radical departure as Congress has consistently recognized and sanctioned the use of the cash basis accounting method since inception of the federal income taxes in 1913. Furthermore, the unit livestock price method of valuing livestock using values based upon reasonable estimates of normal costs of producing animals has been sanctioned by the Treasury Department since 1944 as being required by the problems of valuing livestock inventories. It seems both unjust and without merit to deny the time-honored and workable cash basis and the presently-used unit livestock price methods of accounting to legitimate farmers and ranchers, simply for the purpose of eliminating the relatively few tax profiteers, particularly when they can be eliminated by the proposals of the National Livestock Tax Committee.

(2) "Proper" Accrual Method of Accounting by Livestock Operators is Virtually Impossible to Achieve

Due to the nature of and conditions surrounding livestock operations, the Tax Committee is of the opinion that simplified record keeping and accounting methods, such as the cash basis, are absolutely essential. The great majority of farmers and ranchers use the cash basis system of accounting because of its simplicity. Even the cash basis method of accounting is not easy for some farmers and ranchers to maintain. To force cash basis farmers and ranchers on to a "proper" accrual system would be imposing an impossible requirement on most and a burdensome and unnecessary requirement on all.

This "proper" accrual system would be a virtual impossibility even for the most sophisticated accountants. This is due to the fact that it would be impossible for the farmer or his accountant to differentiate between and properly segregate the costs of raising his breeding livestock from the costs of raising animals held for sale, which would be most essential since gain on the sale of breeding animals held for the requisite holding period is taxed at capital gains rates. In many instances, the farmer or rancher is unable to determine for a significant period of time whether to place an animal with his sales herd or to retain it as a member of the breeding herd. Attempting to allocate costs in these circumstances would test the ingenuity of even the most complex accounting equipment. Similar and greater problems would

develop where, as is commonly the case, the farming or ranching operation includes the raising of livestock as well as the growing and harvesting of crops and other agricultural activities. To allocate in a proper manner the costs of the overall agricultural business to the multifaceted operations involved would be a nightmare and exercise in futility. In the final analysis, it would be an impossibility.

(a) Accurate Inventories Impossible

Unlike other businesses where the production and sale of merchandise is a significant factor and the "proper" accrual method of accounting is required for income tax purposes, ranching and farming is not the type of business where accurate inventories can be made at periodic intervals and meaningful cost accounting methods employed. On many ranches covering thousands of acres, livestock cannot be conveniently located and inventoried on December 31 of each year or at any other such specific date for accounting purposes. The same would seem to apply equally to other agricultural activities.

A number of the most prominent livestock tax accountants in the country have confirmed to the Tax Committee that it would be a virtual impossibility for the livestock operator to conform to the "proper" accrual method of accounting. Furthermore, these accountants stated that the multiple accounting problems involved in attempting to comply with such a "proper" accrual method would be practically insuperable.

(b) "Proper" Accrual Accounting Very Expensive

Even if the "proper" accrual method of accounting were feasible and could be complied with, this would substantially increase the operational costs of the farmer and rancher which are already at a record level. With such additional costs to cope with, and viewing the already existing thin overall profit margin of livestock operations, it is conceivable that the added burden of increasing the complexity of their record keeping and attendant costs would cause many farmers and ranchers to cease operation.

(c) Expert Accounting Assistance Not Available

Furthermore, in a large number of rural areas there are no accountants, or an insufficient number of accountants, to perform the complex bookkeeping chore that would result from imposition of the "proper" accrual method of accounting on farmers and ranchers. For instance, available statistics published by various accounting societies show approximately less than 20% of the total number of certified public accountants in the continental United States practice in the twenty-one states west of the Mississippi (excluding California), yet those twenty-one states comprise about 67% of the land area of the continental United States. It is in these same states that approximately 64% of the nation's cattle population is located according to U. S. Department of Agriculture statistics, yet it is obvious that competent accounting assistance necessary for accurate accrual reporting would be hard to come by

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at least in the western states. Even if the services of qualified cost accountants could be obtained, the additional time and expense which would be spent in trying to justify to the Internal Revenue Service or to a court the method of cost allocation used, which would obviously be subject to very close scrutiny, could be most substantial.

b. Present Law has Built-in Presumption - <u>No Statutory Presumption Needed</u>

Replacing present section 270 of the Internal Revenue Code with this new Hobby Loss Presumption provision would not add any extra arsenal for enforcement of present tax law. This is because under present tax law disallowance of any business loss by a revenue agent is already <u>presumed</u> to be correct until rebutted by the taxpayer. The fact that the Internal Revenue Service has not fared too well in the farm and ranch "hobby loss" area of litigation is probably due to the unfamiliarity of revenue agents with the essential elements of a legitimate operation. A statutory presumption, such as that created by this new provision, would appear to add nothing constructive to present law. It would merely provide a convenient and speedy means by which an examining agent would disallow <u>all</u> losses, regardless of the operator's actual good faith and length of time in the business; and it would substantially increase the time spent by taxpayers and the Internal Revenue Service in extensive tax protests and litigation of such cases.

c. <u>Cost of Enforcement</u>

In the Hobby Loss Presumption provision, no reference

is made as to how farm losses are to be computed. Whether such losses will be computed as under present section 270 of the Internal Revenue Code, whether capital gains will be excluded or included and whether farm income will include income from farm land use is not indicated. This lack of direction in this provision will certainly invoke considerable protests and litigation. Furthermore, protests and litigation rebutting the presumption created by this provision will probably be numerous, necessitating a larger staff and additional funds for the Internal Revenue Service.

In addition, protests and litigation resulting from attempts to rebut the presumption created by the Hobby Loss Presumption and from attempts to police and audit the use of a "proper" accrual accounting system, the excess deductions account, and the carryforward and basis adjustments of LTP will probably be numerous, requiring additional personnel and larger administrative funds for the Internal Revenue Service.

As a matter of conjecture, the Tax Committee wonders whether this cost of enforcement will not exceed the small additional revenue which these provisions may raise.

C. General Objections to Unneeded Provisions of H. R. 13270

1. Would Create Extreme Complexity and Confusion to Livestock Operators

Unraveling, comprehending and applying these unneeded provisions of H. R. 13270 would even be a major undertaking for a professional tax advisor. It would be a virtual impossibility for most farmers and ranchers.

The extreme complexities of and the virtual impossibility of farmers and ranchers complying with the "proper" accrual system of accounting under the EDA, LTP and Allocation of Deductions provisions of H. R. 13270, previously discussed, would only serve to add to the confusion of attempting to comply with these provisions.

Further, the right of such farmers and ranchers under LTP to increase the basis of their farm assets in computing gain or loss by the amount of disallowed farm loss "tax preferences", but limited to the basis of such farm assets computed on a "proper" accrual system or determined by use of reasonable estimates of unit costs, would result in unending confusion. Also, the five-year carryforward provisions of LTP with respect to any remaining disallowed farm loss "tax preferences" would create similar problems. The unreasonable requirement of keeping two sets of separate accounting records would also be necessary in order to determine the "proper basis" adjustment for these farm assets in computing gains or losses.

Maintaining an accurate EDA by all farmers and ranchers not on a "proper" accrual method of accounting would entail further and additional record keeping duties and expenses, which a large number of stockmen would be unable to perform or pay for. Preparing income tax returns, much less keeping the type records required under these provisions, would be a monumental task. In short, most farmers and ranchers would just not be able to grasp, understand or comply with these additional and complex

complications imposed by these provisions of H. R. 13270.

Because of this complexity and the impossibility of maintaining accurate records and properly allocating costs on a "proper" accrual system, farmers and ranchers would be left to the mercy and whims of individual revenue agents. If past events are any indicator, these agents are usually uninformed of the facets of livestock operations and accounting which portends further confusion and expense for stockmen should these provisions be enacted.

As one Treasury Official has stated, perhaps H. R. 13270 should be entitled the "Lawyers and Accountants Relief and Pension Act".

Attached hereto as an exhibit is a statement by Mr. N. E. Tamplin, a partner with the accounting firm of Ernst & Ernst, briefly explaining the complexities and confusion which these unneeded provisions of H. R. 13270 would cause.

2. **Would Discourage Diversification by Farmers and Ranchers into Non-farm Businesses**

a. **Farmers and Ranchers Must Diversify**

For the past several years, because of depressed livestock and crop prices and rising production costs, many farmers and ranchers have had to seek off-farm employment in order to supplement their farm income.

> "The farmer more frequently is moonlighting. The farm housewife more frequently is participating in the nonfarm labor force. Better roads and easier

access to town, increasing demand for nonfarm labor in many areas, increasing need for income by farmers themselves, all play a vital role in this trend. Farmers are diversifying, but off the farm, rather than on it."*

This indicates that off-farm income has become an increasingly important factor in the lives of farm families. For example, in 1967, farmers received $10.7 billion from non-farm sources. Between 1960 and 1967, non-farm income per farm family more than doubled.**

Diversification by legitimate farmers into non-farm activities has become almost a necessity because of the fact that parity is only about 74%. Additionally, it is becoming increasingly apparent that it makes good economic business sense not to have "all your eggs in one basket". Such diversification by long-time legitimate farmers and ranchers in non-farm businesses, of course, means larger off-farm income.

These figures and the move toward diversification show not only the important role non-farm income is presently playing in the farming and ranching economy, but also portend that non-farm income will, as it increases in the future, play even a more vital part in agricultural economic stability.

b. EDA Could Discourage Diversification

Corporations, trusts and estates engaged in farming or ranching and subject to the provisions of EDA would be discouraged

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* M. L. Upchurch, Administrator of Economic Research Service, U.S.D.A., Address to Annual Agricultural Outlook Conference on February 18, 1969.

** Upchurch, Ibid.

to diversify since the offsetting of <u>any</u> farm losses against income from any non-farm source would result in increasing the amount in EDA. Non-farm income could include income from land rentals, royalties, dividends, interest on savings and other similar sources, which are becoming increasingly common to more and more of such legitimate farming and ranching operations.

c. <u>EDA Could Discourage Thrift and the Investing of Non-farm Income in Livestock Operations</u>

When such a typical farm or ranch enterprise has a profitable year resulting perhaps from good moisture and higher selling prices, the prudent operator will want to invest some of the profits so that there will be something to fall back on when a bad year comes along. Often this investment of profits is in a non-farm business because of the desire to diversify. The EDA provisions would tend to discourage such investments, since the income from such non-farm investments would swell the amount in EDA to the extent used to offset farm losses.

Furthermore, non-farm income is often plowed back into the livestock operation to make it more effective. By discouraging diversification, such non-farm income would not be available for increasing the effectiveness or productivity of the operation, and with increasing interest rates, many of such legitimate farmers and ranchers might have to terminate their operations if credit sources dried up.

These are just further indications of the economic unsoundness of this particular provision of H. R. 13270.

d. Existing Government Programs Could be Impaired by EDA

By the same token, these EDA provisions fly directly in the face of existing government programs, such as those sponsored by the Farmer's Home Administration, which are designed to encourage farmers to increase their non-farm income. The objects of such programs are to establish non-farm trades and businesses such as recreational uses and thus provide rural communities with services previously unavailable, while increasing non-farm income. As previously explained, the EDA provisions affecting corporations, trusts and estates engaged in farming and ranching would mean that such taxpayers would be discouraged to receive any non-farm income no matter what the source.

3. Would Isolate Agriculture From Rest of Nation's Economy

These unneeded provisions of H. R. 13270 would have the effect of isolating the livestock industry, and agriculture in general, from the mainstream of our country's economy by discouraging needed outside capital from entering the industry and by hindering many existing legitimate farming and ranching operations to remain economically sound by diversifying into non-farm businesses and investments. This would result in a situation which would be very damaging to this industry which constantly needs new blood and new capital and which has heretofore not been discouraged to diversify into non-farm businesses or investments.

Instead of saving agriculture from outside forces which supposedly distort farm and ranch economics, those unneeded provisions of H. R. 13270 would inflict damage on the legitimate operator who is trying to expand his business and remain on the farm, by reducing his supply of available capital and placing restrictions in one form or another on the deductibility of farm losses. It would, in fact, appear to inflict the most severe damage on the small and medium-sized livestock operations which, unlike the large operations, could not afford to comply with or pay the price exacted by these provisions in the form of additional record keeping and professional tax assistance.

4. Would Impede Vital Agricultural Programs

Many research programs in the fields of agricultural production on farms and ranches are in large part supported by funds from non-farm sources.* These unneeded provisions of H. R. 13270 would seriously impair these programs which are beneficial to the entire economy, farmers and consumers alike, by discouraging investment and participation in research. The reason these programs reflect losses is for the simple reason that they are not designed to show immediate profitable returns in cash, but are profitable in long-term breed and biologic improvements for the whole industry.

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* See Logan, Evaluating Financial Support of Research Programs, Journal of Farm Economics (Feb., 1964).

Closely related to these research programs is the vital role played in the livestock industry by purebred operations. These operations, which are analogous to engineering and research departments in certain industrial businesses, are the foundation of the entire livestock industry since they provide the seed livestock for all livestock operations. Because of the extensive research and experimentation involved in these operations, the profit reflected is often very small and in many instances there are sustained losses for a number of years until an improved seed stock animal is developed and recognized by the industry. To restrict or deny the full deductibility of the losses incurred in these operations in any manner, whether by reducing capital gains on the sale of livestock under EDA, by a hobby loss presumption, by increasing taxable income under LTP, or restricting the deductibility of certain itemized personal expenses under Allocation of Deductions, would be unfortunate; it would discourage, and possibly eliminate, the needed flow of capital from non-farm sources into these research programs, and it would have the resultant and adverse effect of restraining the production and development of needed seed stock. Already there seems to be developing a trend away from cow-calf operations to steer operations because of lower operational costs associated with raising steers. This forecasts a far more serious development, since there has to be some entity or group producing seed stock for the livestock industry.

5. **Would Dry Up Needed Sources of Outside Capital and Restrict Entry of New Blood into Industry**

Enactment of these unneeded provisions of H. R. 13270 would almost certainly place a restriction on the availability of capital for farming purposes from outside sources. This could be severely damaging to agriculture which has been largely dependent upon the availability of outside capital.

a. Large Amounts of Outside Capital Necessary

Livestock operations need large amounts of capital to begin and continue operations, and very often this capital is not available from the farmer's or rancher's own resources or borrowings. Thus, attraction of outside capital always has been important to the livestock industry. Any law, such as these unneeded provisions of H. R. 13270, which would discourage new capital investment, could prove catastrophic to the whole industry. Productivity could decrease, operation costs would increase, husbandry and agricultural practices would deteriorate, and local communities and other businesses would disappear. The entry of new capital into the livestock business, particularly in the western states, has a long historical background.* American agriculture was built largely by outside capital. It is this capital which makes efficiencies resulting in the United States being the most productive agricultural nation in the world.

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* See Gray, Ranch Economics (1968).

Further, it should be recognized that the small and medium-sized family farm or ranch is having its hardest financial time in history.* The increased cost of machinery, supplies, feed, and such other necessary products and equipment is such that a small operation cannot justify it. For this reason, many such operations are amalgamating with the assistance of outside capital and thereby developing efficient and larger units over which the costs of operation can be more economically spread. To effect this, such farmers and ranchers need and are entitled to operate under the tax laws without these detrimental provisions.

b. Essential Flow of New Blood into Industry Would be Stifled

The average age of a farmer today is about 55. With expanding and lucrative opportunities in other businesses, agriculture has not kept pace with encouraging new people to enter the industry on a legitimate basis. With an average rate of return on capital investment of between 1% and 3% (and in certain areas of the country the rate of return is below 1%),** there need to be incentives not barriers placed in the way for such new people to come into agriculture. Instead of creating such essential incentives, these unneeded provisions of H. R. 13270 erect barriers.

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* See generally Food Costs - Farm Prices, Committee on Agriculture House of Representatives (90th Congress, 1st Session, July, 1967).

** Based upon compilation of studies conducted by U. S. Department of Agriculture, national livestock associations, and colleges and universities.

Start-up costs for any legitimate livestock operation could and usually do result in losses for the initial years of operation, subjecting the operations to some if not all of those unwarranted and detrimental provisions of H. R. 13270.

In addition, these unneeded provisions of H. R. 13270, in combination or in single application, would make it virtually impossible for a person to borrow sufficient capital to purchase a farm or ranch or to acquire a farm or ranch subject to a mortgage. This is because the interest on the mortgage and the higher and higher property taxes being levied against agricultural property would increase farm losses. Under EDA, this could result in reduction of the full deductibility of such expenses by reason of the required offset of EDA against capital gain. Under the Hobby Loss Presumption, it could result in all farm losses being disallowed if they exceeded $25,000 for any three of five consecutive years, as they well might in the initial years of operation. Under LTP, these losses could result in increasing the taxable income of the farmer or rancher. Under Allocation of Deductions, these losses could cause the reduction of the farmer's or rancher's itemized personal deductions.

6. Could Result in Substantial Meat Price Increases to Consuming Public

a. Livestock Currently Produced at Low Prices

Improvement of livestock breeds through dedicated research programs, as previously noted, has produced overall meat prices at lower prices to the consuming public than practically

anywhere else in the world. However, the livestock business receives no governmental subsidy for raising meat. The livestock producer operates as an individual with no bargaining power and is unable to set the price at which he buys or sells his livestock. As a matter of fact, livestock producers who are still operating at below parity prices subsidize the consumers. Still, the livestock business, because of its high capital investment requirements and slim profit margins caused by increasing operational costs and fairly static livestock prices, receives one of the lorest returns on its investment of any business.

b. Food Costs Presently a Bargain

Under the present income tax system, and notwithstanding the distressed economic condition of the industry, American agriculture has done an outstanding job in fulfilling the nation's food and fiber needs. In fact, food and fiber have been supplied by the industry to the consuming public at bargain prices. This is evidenced by the fact that according to the American Meat Institute Bulletin of May 20, 1969, the working man today spends 17% of his income for food, whereas 20 years ago he spent 26% of his income for food. In contrast, the average family in Italy spends about 38% of its disposable income for food, and Peruvian and Russian families spend about 56% of their income for food.

Even in light of these bargain food prices for the American public, operators are still receiving prices below parity for their livestock. Until the slight upsurge in livestock prices a few months ago, livestock prices were about the same as 20 years

ago[*] although production costs have increased by about 105%.[**] As a matter of fact, since 1950 livestock prices received by operators were on the average <u>below</u> the total costs of production for most of those years.

c. <u>Provisions of Act Could Increase Meat Prices</u>

Enactment of these unneeded provisions of H. R. 13270 could well result in a substantial increase in meat prices to the consuming public. By discouraging the entry of needed outside capital and new blood into the industry and by driving many small and medium-sized operators out of the business, it is very likely that as a result of these provisions, livestock numbers will be substantially decreased, causing a corresponding rise in meat prices.

IV. SOME SECTIONS OF H. R. 13270 ARE SIMILAR TO PROPOSALS OF NATIONAL LIVESTOCK TAX COMMITTEE AND WOULD PREVENT TAX PROFITEERING WHILE NOT HARMING LIVESTOCK INDUSTRY

Included in H. R. 13270 are two specific provisions extending depreciation recapture rules to livestock and increasing the holding period for livestock to qualify for capital gains treatment. The provision on depreciation recapture is the same as one of the proposals offered by the National Livestock Tax Committee, while the provision relating to an increased holding period for livestock has been modified slightly from that proposed by the Tax Committee.

A. <u>Depreciation Recapture Rules Applied to Livestock</u>

Depreciation allowed or allowable on purchased livestock

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* See <u>Food Costs-Farm Prices</u>, Committee on Agriculture, House of Representatives (90th Congress 1st Session July, 1967).

** See Agricultural Statistics, U. S. Department of Agriculture Table 695 (1967), Table 684 (1968).

used for dairy, breeding or racing purposes would, under the provisions of H. R. 13270, be subject to the depreciation recapture rules of present law, as are all other similar business assets. This would mean that gain realized on the sale of such livestock would be taxed at ordinary income rates to the extent of depreciation claimed or allowable on such animals, and the remainder of the gain, if any, would be taxed as capital gains, if holding period requirements had been satisfied.

The Tax Committee feels that this proposal is fair and equitable in that it equalizes the tax burden among livestock operations and other businesses and since it will discourage the entry of tax profiteers into the livestock industry.

B. Increase in Holding Period for Livestock

H. R. 13270 provides that, in order to qualify for capital gains treatment, the holding period required for livestock held for draft, breeding and sporting or dairy purposes will be at least 365 days after such animal normally would have been used for any of such purposes.

The Tax Committee feels that, although some modifications are called for, this proposal in the main is fair and equitable and will help prevent tax profiteering.

Such modifications would include a clarifying provision that the use of animals for breeding, dairy or racing purposes from which the 365-day holding period is measured, shall be based on the time in each taxpayer's own operation that such use normally commences. This will assure equitable treatment of all farmers and ranchers, since the first use of animals for such purposes normally varies from region to region and from farm to farm within a given region.

The second modification which would be included is that there be a presumption of First In, First Out, as under the present unit livestock price method of inventorying livestock if the animals are not individually identifiable (as in most commercial range operations). Such presumption would assist in determining the age of raised livestock, since such age is difficult to determine by weight (method commonly used) after an animal exceeds two years of age. Inclusion of such a provision would also make administration of this provision easier and more effective, including verification of returns by revenue agents.

A third modification would be to exempt from this increased holding period requirement, as does the proposal of the National Livestock Tax Committee, animals subject to involuntary conversion due to drought or disease. The reason for this exemption is that premature disposition of such animals results from circumstances beyond the taxpayer's control.

C. Proof of Intention for Holding Livestock

One of the proposals suggested by the Tax Committee was that to claim capital gains on the disposition of livestock, a taxpayer be required to prove the purpose for which he held the livestock in addition to showing the length of time they were held. In adopting this proposal, the House Ways and Means Committee Report refers to the fact that ". . . the mere satisfaction of the holding period requirement in the case of livestock should (not) . . . be considered to conclusively demonstrate that the animals were held for breeding purposes (or any of the other specified purposes). . . . This determination should be made on the basis of all the facts

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and circumstances which may indicate the purpose for which the animal was held."

D. Tax-Free Exchange of Livestock

Another proposal offered by the Tax Committee was that present law be clarified to show that it is not proper to exchange male calves or steers tax-free for female calves or cows. This proposal was also adopted by the House Ways and Means Committee and appears in its Report on H. R. 13270, where it is stated that ". . . Congress did not intend this type of exchange to be considered a like-kind exchange."

E. Treatment of Land Improvement Expenses

Under EDA, gain realized on the sale of farm or ranch land would be recaptured and taxed at ordinary income tax rates to the extent of land clearing and soil and water conservation expenses deducted in the five years previous to the sale. Since such expenses are frequently incurred and deducted on a continuing yearly basis, this would result in the gain realized on the sale of much farm or ranch land, which is presently taxed at capital gains rates, being taxed at the higher ordinary income rates, thereby reducing the overall profit. Such a provision could cause considerable harm to a large number of farmers and ranchers who only reap a substantial profit when their land is sold.

Adoption of the National Livestock Tax Committee's proposal for recapturing these land clearing and soil and water conservation expenditures on a graduated basis if farm or ranch land is sold within 10 years after acquisition would be more

equitable and would not cause harm to the legitimate long-term farmer and rancher, since such proposal is based on the length of time the farm or ranch land was held and not when these expenses were sustained. In addition, the National Livestock Tax Committee's proposal would have the beneficial effect of encouraging the improvement of farm and ranch land by permanent operators, yet discouraging the purchase of farm and ranch land by tax profiteers on a short-term basis.

F. Income Averaging Provision Would be Beneficial to Industry

The Tax Committee supports the sections of H. R. 13270 improving and simplifying the income averaging provisions of the tax law.

V. TAX PROFITEERING NOT WIDESPREAD AND IS DECREASING

A. Basis for "Farm Loss" Provisions is Incomplete

The basis and reason for enactment of the "farm loss provisions" of H. R. 13270 is found in the statement in the House Ways and Means Committee Report that according to Treasury Department data for the years 1964 to 1966, "as the taxpayer's adjusted gross income level increases, the size of the average farm loss also consistently increases."

This statement is incomplete and fails to recognize the entire economic picture. For the years 1963-66, the 1966 Statistics of Income, Individual Income Tax Returns compiled and reported by the Treasury Department, analyzing individual

income tax returns filed and sources of income, reveals that returns filed by individuals showing net farm losses amounted to only about one-third of the total returns filed showing farm income and losses. This 1966 Report further indicates that the number of returns reporting net farm losses has decreased from 1,086,000 in 1963 to 1,012,000 in 1966. Also significant is the fact that these returns reflect a slight decrease from $1,902,000,000 in farm losses in 1963 to $1,853,000,000 in such losses in 1965. If as alleged, a large number of high-income-tax bracket individuals are being attracted into farming for tax write-off purposes, it would appear that the number of returns showing farming losses would have increased substantially since 1963 inasmuch as the total number of tax returns filed in 1966 by all classes of taxpayers increased 9.7% over 1963.

From the all inclusive application of these "farm loss provisions" of H. R. 13270 to farmers and ranchers, it might be concluded that tax profiteering operations were widespread. This is not true as the 1966 Report shows that, except for the $600 and under adjusted gross income bracket, where the aggregate amount of net farm losses exceeded net farm profits, only in the $100,000 and above bracket did net farm losses exceed net farm profits. Further significant is the fact that only 3,598 returns (.001% of total farm returns) were filed showing net farm losses in the $100,000 and above tax bracket.

B. Farm Losses not Significantly Different from other Business Losses

Also relevant is the fact that the 1966 Report reveals that more losses were reported by individuals in the $100,000 and above adjusted gross income bracket with respect to other businesses and professions than by individuals in the same income bracket who reported net farming losses. This is revealed in the following excerpt from the 1966 Report:

Adjusted Gross Income Classes	Business or Profession (Net Loss)	Farm (Net Loss)
$ 100,000 under $ 200,000	$43,473,000	$38,375,000
200,000 under 500,000	32,047,000	25,605,000
500,000 under 1,000,000	10,304,000	9,207,000
1,000,000 or more	16,045,000	3,729,000

However, no other businesses are singled out for discriminatory tax treatment by subjecting them to an EDA or by including their business losses as "tax preferences" under the LTP and Allocation of Deductions provisions of H. R. 13270.

If the basis for enactment of those "farm loss provisions" of H. R. 13270 is predicated on the statement that the size of the average farm loss increases consistently as adjusted gross income rise , then closer scrutiny of such Treasury Department data is required. This is because this same Treasury Department data set forth in the following table reveals that the size of the average loss from non-farm businesses and professions also increases consistently as adjusted gross income rises.

1965

AGI Classes (thousands)	Number of Returns	Net Business Loss (thousands)	Average Loss
$0-$5	448,749	$1,064,775	$ 2,372.76
$5-$10	282,121	256,116	907.82
$10-$15	99,319	114,895	1,156.83
$15-$20	28,692	49,787	1,735.22
$20-$50	29,951	101,444	3,387.00
$50-$100	6,176	53,460	8,656.09
$100-$500	2,728	63,115	23,136.00
$500-$1,000	149	8,471	56,852.35
$1,000 & over	97	14,591	150,422.68

1966

AGI Classes (thousands)	Number of Returns	Net Business Loss (thousands)	Average Loss
$0-$5	429,151	$1,117,336	$ 2,603.59
$5-$10	306,737	328,222	1,070.04
$10-$15	115,863	140,939	1,216.42
$15-$20	38,350	64,358	1,678.17
$20-$50	36,910	134,968	3,656.68
$50-$100	7,265	64,558	8,886.17
$100-$500	3,128	75,520	24,143.22
$500-$1,000	180	10,304	57,244.44
$1,000 & over	99	16,045	162,070.70

Yet, these non-farm businesses and professions are not subjected to EDA or are those non-farm losses classed as "tax preferences" under the LTP or Allocation of Deductions provisions of H. R. 13270.

C. Average Farm Profit also Increases Consistently as Adjusted Gross Income Levels Rise

An examination of this same Treasury Department data further shows that the size of the average farm profit also

generally increases as adjusted gross income rises. This is reflected in the following table.

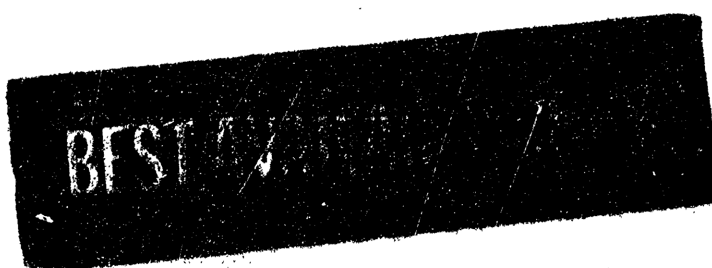
1965

AGI Classes (thousands)	Number of Returns	Farm Net Profit (thousands)	Average Profit
$0-$5	1,243,666	$1,767,545	$ 1,421.23
$5-$10	532,485	1,760,012	3,305.27
$10-$15	135,458	754,027	5,566.50
$15-$20	42,776	352,551	8,241.79
$20-$50	39,003	474,633	12,169.14
$50-$100	4,984	83,027	16,658.71
$100-$500	1,045	23,521	22,508.13
$500-$1,000	32	518	16,187.50
$1,000 & over	17	1,671	98,294.12

1966

AGI Classes (thousands)	Number of Returns	Farm Net Profit (thousands)	Average Profit
$0-$5	1,100,435	$1,618,827	$ 1,471.07
$5-$10	596,475	2,058,458	3,451.03
$10-$15	186,213	1,055,339	5,667.37
$15-$20	57,004	504,127	8,843.71
$20-$50	49,889	630,545	12,638.95
$50-$100	5,642	92,852	16,457.28
$100-$500	1,201	25,191	20,975.02
$500-$1,000	27	620	22,962.96
$1,000 & over	15	172	11,466.66

From the foregoing statistics showing the relative size of net farm profits and losses, it would appear that in general the larger the operation the greater are the size of both profits and losses. This is because a business such as farming and ranching which is subject to so many elements



beyond its control can either have a profit or a loss in any given year, and the amount of the profit or loss of a particular operation can be and is frequently in direct proportion to its size. Under these conditions, and based on the foregoing statistics, singling out the entire livestock industry for discriminatory tax treatment under these unneeded provisions of H. R. 13270 is not warranted or justified.

D. Drawing Farm Loss Demarcation Line at $15,000 or $25,000 not Justified

H. R. 13270, under its Hobby Loss Presumption and EDA provisions, would treat even legitimate farmers and ranchers who incur farm losses in excess of $25,000 for one year or a period of years as "hobby operators" and restrict the amount of capital gains they could claim on the sale of their livestock or other farm property.

In similar manner, the official position of the Treasury Department as stated by Mr. Edwin S. Cohen before this Committee on September 4, 1969 is to treat even legitimate farmers and ranchers as non-bona fide operators if farm losses exceed $15,000 under EDA and to include all losses in EDA if such farmer's or rancher's non-farm adjusted gross income is also in excess of $25,000. As an apparent basis for this conclusion, Mr. Cohen stated that:

> ". . . large farm losses generally represent capital expenditures which have been deducted under the liberal cash method of accounting. The cash method has been allowed to farmers primarily to help small

farmers, but taxpayers with large farm losses are generally not in this class but are wealthy investors who obtain a tax shelter." [Emphasis added.]

This statement is too general. For instance, there are no statistics cited by Mr. Cohen or of which the Tax Committee is aware that show that large farm losses generally represent capital expenditures which have been deducted under the cash basis. Further, the cash basis is under present law allowed to all farmers and ranchers, regardless of their size, and is necessary because of the nature of livestock operations. To restrict or deny farm loss deductions or use of the cash basis by legitimate farmers and ranchers who, because of the size of their operation, incur large losses (or profits) in a certain year or period of years is not justified. Many legitimate and lifetime farmers and ranchers have farm losses in excess of $15,000 or even $25,000. One bad storm alone can cause this much of a loss in one year.

To classify legitimate lifetime farmers and ranchers as "wealthy investors" seeking a tax shelter just because their farm losses exceed $15,000 or $25,000, besides being unsubstantiated, is not warranted. The amount of farm losses (or even the amount of non-farm income) a farmer or rancher sustains is no indication, nor should it be, of whether he is in the business on a legitimate basis.

Mr. Cohen stated that under the Treasury-modified EDA only 9,300 individuals, with farm losses aggregating $418 million, would be affected. This statement implies that this is an

insignificant number of farmers and ranchers and only a relatively few wealthy taxpayers will be affected. Yet, according to Treasury Department data for 1966, there are 9 states where there were about 9,300 or less returns filed by farmers and ranchers. These states are: Arizona (6,784), Connecticut (5,299), Delaware (5,010), Hawaii (4,002), Maine (9,753), Massachusetts (5,283), Nevada (1,941), New Hampshire (2,766) and Vermont (5,918). Further, this same Treasury Department data reveals that a $418 million farm loss would be approximately 22% of all farm losses in 1966 and would represent about 7% of the total net farm profit reported for that year.

VI. TAX COMMITTEE ALSO OPPOSED TO PROVISIONS AND PRINCIPLES IN METCALF AND MILLER BILLS

In addition to the unneeded provisions of H. R. 13270, the Tax Committee is also opposed to the provisions and principles embodied in S.500, introduced and sponsored by Senator Lee Metcalf of Montana and S.1560, introduced and sponsored by Senator Jack Miller of Iowa, which would restrict or totally deny the deduction of farm losses. Although these bills are obviously intended in good faith to help the livestock industry, the Tax Committee feels that these bills would seriously harm the whole industry and perhaps cause the greatest damage to the small and medium-sized family farms and ranches.

Under Senator Metcalf's bill, farm loss deductions would be restricted or totally denied to farmers or ranchers who were not on a "proper" accrual method of accounting and who had non-farm income in excess of $15,000. Legitimate farmers or ranchers who earned $30,000 of non-farm income would have all farm losses disallowed. Treasury data for 1966 reveals that this bill would adversely affect at least 79,263 returns (reflecting adjusted gross income above $15,000) and possibly more,* a number equal to approximately the total returns reflecting farm income or loss filed by all persons in the State of Oklahoma.

Legitimate farmers and ranchers who are elected to political office and who receive more than $15,000 would find their farm loss deductions restricted and in some cases completely disallowed. The ramifications of this could discourage qualified legitimate farmers and ranchers from entering public life.

In recent Congressional hearings on federal grazing fee increases, Senator Clifford Hanson of Wyoming, noting that profits in the livestock business have been low, stated that: "I've had to find outside employment to keep my livestock business going." This statement is generally applicable

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* Since losses from business operations, including farming and ranching, are deducted from gross income in arriving at adjusted gross income, it is possible that the number of farming operations affected by this proposal could be well in excess of 79,263.

throughout the livestock industry and is supported by statistics which reveal that in recent years, non-farm income received by each farm operator family almost equals total net farm income.*

The previously discussed adverse and detrimental effects of the unneeded provisions of H. R. 13270 are also generally applicable to Senator Metcalf's bill. They would include forcing many farmers and ranchers on the impossible "proper" accrual system; restricting the flow of needed new blood and legitimate outside capital into agriculture; discouraging diversification and investment in non-farm businesses by farmers and ranchers; impairing existing and proposed Government programs; impeding vital agricultural research programs; isolating agriculture from the rest of the nation's economy; and jeopardizing the credit base of agricultural lands.

Senator Miller's bill would in general prevent the deduction of farm losses if farm income did not equal or exceed two-thirds of total net income. Although this bill would not have the effect of forcing farmers and ranchers on to a "proper" accrual method of accounting, it follows basically the same underlying and objectionable principle of Senator Metcalf's bill in that it would base disallowance of farm losses on the amount of non-farm income earned by a legitimate farmer or rancher.

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* M. L. Upchurch, Administrator of Economic Research Service, U. S. Department of Agriculture, Address to Annual Agricultural Outlook Conference on February 18, 1969.

VII. SENATOR GORE'S BILL (S.2645) A PARTIAL SOLUTION

S.2645 introduced by Senator Albert Gore of Tennessee contained a specific provision (Section 13) pertaining to suggested changes in the livestock tax laws. Senator Gore's bill would: (1) provide that the Secretary of the Treasury could not prescribe in his regulations for the useful life of livestock held for breeding purposes to be less than 10 years; and (2) extend the holding period for livestock from 12 months to 24 months in order to qualify for capital gains treatment.

Because of its simplicity and ease of application, and the fact that it would be at least a partial solution to eliminating tax profiteering in the livestock industry, the National Livestock Tax Committee feels there is considerable merit in the provisions and approach taken by Senator Gore's bill.

However, the Tax Committee is of the opinion that in order to meet the objectives of an equitable and sound tax system, the depreciation recapture rules of present law which apply to all depreciable personal property, other than livestock, should also be extended to livestock. In this sense, including livestock under the depreciation recapture provision of present law would make the restriction on useful life provision in Senator Gore's bill unnecessary.

VIII. CONCLUSION

PROPOSALS OF NATIONAL LIVESTOCK TAX COMMITTEE WOULD ELIMINATE TAX PROFITEERING WHILE NOT SUBSTANTIALLY HARMING INDUSTRY

Since the National Livestock Tax Committee is convinced that this Committee is intent on maintaining an equitable and sound tax system and not inflicting harm on the entire industry, it is the urgent request of the Tax Committee that this Committee amend H. R. 13270 to include just those proposals offered by the Tax Committee, with the suggested modifications previously noted, that are contained in this bill and referred to in the House Ways and Means Committee Report. These proposals would preserve for the serious permanent farmer and rancher the time-honored and essential cash basis and presently used unit livestock price methods of accounting, retain capital gains for livestock, and permit all farmers and ranchers the right to deduct currently the costs of soil and water conservation, fertilizing and land clearing under sections 175, 180 and 182 of the Internal Revenue Code. At the same time, these proposals would put an end to tax profiteering by a few whose only motive is to enter the livestock and farming business on a short-term basis to make a tax profit.

The National Livestock Tax Committee strongly feels that the enactment of the unneeded provisions of H. R. 13270 would be contrary to an equitable and sound tax system, would constitute an "overkill", would add complexity and confusion to the tax law, would radically change the accounting and economics of the industry, and could result in higher meat prices to the consuming public.

E X H I B I T

ERNST & ERNST

FIRST NATIONAL BANK BUILDING

DENVER, COLORADO 80202

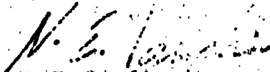
September 13, 1969

Senate Finance Committee
2227 New Senate Office Building
Washington, D. C.

Gentlemen:

The proposed income tax law now being considered by you creates unrealistic complexities of computation in the agricultural area. Not only does the taxpayer engaged in agriculture have to cope with the inordinate complexities of the entire reform proposal, he alone has the problem of maintaining an excess deduction account with its carry-over provisions and limitations and special rules on farm land. This coupled with a limited tax preference, with carry-over provisions, and allocation of deduction rules that apparently forces an individual taxpayer to compute a loss on profit on agricultural operations on a strict accrual method seems to involve more computation and record keeping than seems practical, or even possible, in the normal agricultural operation. The interplay and interrelation of these complex provisions, which will not be understood or even interpreted for years, coupled with the already complex and little understood rules on operating loss and capital loss (this being changed also) carryforwards will obviously result in lack of compliance and difficulty in enforcement. Tax reform does not imply simplicity, but it should not create impossible complexities such as this.

Very truly yours,



N. E. Tamplin
Partner

NET/Wa

STATEMENT OF JOHN B. CONNALLY
HOUSTON, TEXAS

ON BEHALF OF THE

LIVESTOCK PRODUCERS COMMITTEE

WITH RESPECT TO H. R. 13270

I. Introduction

My name is John B. Connally of Houston, Texas, where I practice law. I am appearing here on behalf of the Livestock Producers Committee, a group of approximately 50 farmers and ranchers in the Southwestern United States. I should add, however, that since I was raised on a farm and have owned farms and ranches in Southwest Texas since 1951, I am also appearing on my own behalf.

II. Current Economic Situation in Farming and Ranching

Many of you are familiar with the deplorable economic situation of the farmer and rancher in the United States. Nevertheless that economic situation should be outlined and illustrated as a backdrop to an examination here of some of the provisions of "The Tax Reform Act of 1969" with respect to agriculture.

One of the witnesses before the Ways and Means Committee in the hearings on this bill referred to the "tragic

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cost-price squeeze" on those engaged in American agriculture. I could not agree more; we have a crisis arising from the costs of the farmer-rancher rising faster than the proceeds from his production. For all of this century those in the agricultural business have bought in a seller's market and sold in a buyer's market.

This "squeeze" is illustrated graphically by Chart 1. You will note that since 1950, the earliest year shown, the major costs of producing livestock have risen steadily but the retail price of livestock, particularly beef, has risen only slightly. Now only 16% of the consumer's disposable income, the lowest percent in modern history, is spent on food, which is the greatest bargain in the American marketplace.

A rancher has been able to absorb these spiraling production costs without comparable meat price increases only by cutting his profit margin to the vanishing point. For example, to obtain an economic profit of $3,100 in the cattle business today, a recent Texas A&M University study concluded that an investment of $112,000 was needed,

a return of less than 3%. Even that return is inflated because it does not include anything for the rancher's labor or overhead. If the rancher paid himself just the minimum wage, his "profit" from this $112,000 investment would vanish, to be replaced by a loss.

In spite of this bleak economic picture, obviously the livestock industry has survived, and continually developed better quality products, without receiving any of the approximately 3 billion dollars in direct annual payments that the United States Government has made under the crop price support programs.[1]

This remarkable result has been achieved partly through the dedication to a way of life of those living on farms and ranches, demonstrated as a heritage of their forebearers, but perhaps more importantly, it has come from a continual infusion of new capital from the other segments of the American economy. That new capital is evidenced by the increasing amount of nonfarm income that is earned by farmers and ranchers. Some of that money comes from the earnings of those who have lived on a farm or ranch all of their lives, but more of it

at the present time comes from those who live part time in urban communities but desire to return or begin to spend time and money in the rural community. These are the people who are experimenting with the new types of livestock that give more eatable beef per animal than ever before, who produce more calves per mother cow than ever before and who bring that calf to market at a greater weight; these are the people who are developing the new grasses and weed killers; these are the people who have spent the enormous sums necessary for soil conservation and to restore the water level.

<u>The Need for Outside Capital</u>

As much as we would like to think of agriculture as being a self-supporting, self-perpetuating industry, the data demonstrates that capital outside of agriculture is a necessity for its survival. Agriculture, in fact, requires great quantities of new capital, usually far beyond the quantity commonly available to the typical farm or ranch producer. This is particularly true when we look at the capital requirements to build up cattle breeding herds and similar livestock ventures. Not only do the animals themselves require a tremendous

maintenance cost, but for the first year or two and maybe even three, they must be maintained with no basic return to the herd. Some individuals, of course, purchased mature breeding stock but most herds are started with young heifers or even calves born on the place. Regardless of the acquisition age the incidents of non-fertility, disease problems, and wrong types of animals often requires heavy culling during the first few years of a breeding herd development. Revenues during this period are extremely low and the results frequently lead to unprofitable operations for several years.

In a recent publication from Purdue University the author made the following statements regarding capital availability:[2]

> Financing and capital avilability has played an important part in the development of the beef industry. The quantity and availability of capital has influenced the development and production of feeder cattle, cattle feeding, processing, and the distribution of beef to varying degrees almost since the establishment of the industry.
>
> This willingness and ability of outside financing to invest in the various aspects of producing cattle and feeding

them had undoubtedly been a factor contributing to the continued expansion of the industry during recent years. . . .

Cattle feeding certainly could not have progressed to the point it has in terms of size and scale of operation without the availability of large amounts of capital. . . . Investments totaling several millions of dollars in both fixed and operating capital are not uncommon for these operations.

Outside capital flowing into agriculture has resulted in improved land, developed new breeding stock, refined technological developments, and has paid for public and private agricultural research.

Beyond this, as General Rudder will discuss more fully, it has also been responsible for thousands of demonstration farms at the local county level. The entire concept of demonstrations, which are usually handled by the local county agricultural agents, depend upon the ability of the agricultural producer to withstand the additional costs involved in adjusting his production, maintaining additional records, and encompassing additional cost expenditures, to

demonstrate a new technological development or new technique to his neighbors.

It must be recognized that much of the land clearing, brush removal, stock pond building and improved pasture development which has occurred in the United States in the livestock production areas has, in fact, been accomplished by the larger producer. The real issue at stake is whether or not this individual will continue to improve the agricultural productivity of the Nation's farmlands, if he is discouraged by the Federal tax laws.

The battle against brush is a continuing one, and it is one in which, even for all the monies which have been expended, we seem to be losing. Massive water development plans for the Southwestern part of the United States can, in fact, transform these arrid regions into virtual productive gardens. In the meantime, however, such areas of the country must depend upon the private and personal sector of the economy to provide stock ponds for livestock and privately financed irrigation projects in order to maintain the

productivity of the area. All this can be placed in jeopardy and good sound range management conservation measures abandoned if the present tax laws are changed (except for the provisions suggested herein).

The tremendous investment involved in land improvements is emphasized in the _Journal of Farm Economics_ by Philip M. Raup.[3]

> In accounting for recent land-value increases it is also appropriate to examine recent investments made in land and consequent improvements in the quality of the land input. One of the most prominent investments in quality improvements has been soil conservation, including structures, land-protective measures, and tillage practices. Another prominent investment in land has resulted from rural electrification, improved water supply, and water distribution and storage systems.
>
> Between 1932 and 1959 a total of 7 billion dollars was spent for conservation purposes in the U. S. Some part of this, and perhaps the major part, has had long-run effects on the quality of the land factor, and should be reflected in higher values.

Frequently, it is these farmers and ranchers with substantial outside capital who have been the major supporters of agricultural research at the Experiment Station in land grant universities through private

research fund donations. A study performed in California and reported in the *Journal of Farm Economics* indicates that not only has the financial support of such groups and individuals been quite substantial but that the time lag between the initial project instigation and the actual accomplishment of the technological advancement has been shortened considerably through the use of these additional funds.

Probably no one statement has best expressed the real needs for increased capital in agriculture than that made by Mr. Gene L. Swackhamer with the Federal Reserve Bank of Kansas City.[4]

> The change in agriculture that we now perceive is not a sudden development--only our attention has made it seem so. Small-unit agriculture was the dominant feature of our agrarian past. The family farm was cherished and protected because it represented the very best that our democratic society could offer to man. The farmer was laborer, manager, and, generally, land-and-capital owner all in one. At his best, he was an entrepreneur in the truest sense.
>
> . . . Yet, almost from the day the first fence went up in the prairie, agriculture was undergoing change.
>
> . . . Land, labor, and capital are still agriculture's principal resources, and

the farmer is still the entrepreneur masterminding their productive combination. Yet, the mix of resources is ever changing and the entrepreneural role of the farmer is much changed from the nearly self-sufficient status of pioneer farmers.

. . . In addition to changes in farm size, the land tenure pattern of farming has moved toward part ownership. As reported by M. L. Upchurch, Administrator of the USDA's Economic Research Service, only 7 per cent of full owners had farms with sales of $20,000 or more in 1964, compared with 24 per cent of the part owners and 16 per cent of tenants.[5]

. . . Capital has become agriculture's fastest growing productive resource. This, too, can be seen in Chart 1. The use of purchases nonfarm resources such as machinery, equipment and production items has increased the need for agricultural credit. The use of credit in agriculture has been expanded rapidly since 1950, while the total farm economy has been growing at a more modest rate. Cash receipts from farm marketings have increased at a 2.5 per cent average annual rate, compared with nonreal-estate farm debt which has increased at an average annual rate of 8.6 per cent. The average annual increase in realized net farm income since 1950, however, has been only about .8 per cent--reflecting increasing input prices relative to product prices, and the use of a higher proportion of purchased inputs. Clearly, accumulating sufficient capital for efficient farming

is a problem--implying that the need for farm credit will continue to be extensive.

Another aspect increasing the capital requirements for maintaining a large beef breeding herd is the growing size of the market. Today the United States has become a major exporter of beef breeding cattle. During the year 1968, exports of beef breeding cattle reached an all time high of slightly over 20,000 head. This represented an increase of 17% over the 1967 level. Most of this increase was due to increased exports to Chile and Canada, although Mexico continues to be the leading export outlet for U. S. beef breeding stock. Venezuela ranks as the second most important market with Canada third, and Chile fourth.

Other countries which purchase substantial numbers of U. S. beef breeding cattle are Guatemala, Costa Rica, Ecuador, Brazil, Panama, Republic of South Africa and the Phillipine Islands.

The Hereford breed led all others numerically in 1968, but the Brahman breed ranked second in importance. It is interesting to note that high on the list of breeds of cows exported are the American developed breeds of

Santa Gertrudis, Beefmaster, Brangus, Charbray and Braeford as well as various other cross-breds that were not identifiable as to breed.

The exportations of beef breeding cattle requires tremendous capital. This capital is utilized in advertising, contracting, litigation, foreign trips and numerous merchandising techniques required to conclude such sales. Such foreign sales cannot be undertaken by individuals with limited capital. The beef breeder who desires to enter this foreign market must have the financial resources to withstand all the normal market development costs involved.

The leading State in the United States for the exportation of beef breeding cattle is Texas. Not only does Texas account for well over one-third of all the beef breeding cattle exported from the United States but it, together with Florida, accounts for almost 60% of the total of such exports. Two-thirds of all the exports of beef breeding cattle in the United States are from the States of Texas, Florida, Arizona, New Mexico and California.

The Ports of Houston and Galveston are the major points of debarkation for the United States exportation for beef breeding cattle, particularly those destined for Latin American countries.

The exportation of beef breeding cattle represents a rare event to the agricultural field; it is one of the few livestock commodities that is exported from the United States, and one of the even more rare commodities that is exported for cash, and not under a government subsidized program. Such exportations, therefore, accomplish numerous goals: (1) they gain foreign exchange for the United States; (2) they provide higher quality animals to foreign countries which, in turn, can be utilized to upgrade their own domestic herds, and (3) they offer the seed of a new commodity - beef - which can be used to raise the standard of living in these underdeveloped countries.

The magnitude of agriculture's economic impact upon the supplying industries is tremendous, and can be best illustrated by the following passage which is

taken from the introduction in the *Yearbook of Agriculture*, 1968:[6]

> In the mid-1960's, farmers were spending annually about 3.4 billion dollars for new farm tractors and other motor vehicles, machinery, and equipment - providing jobs for 120,000 employees.
>
> They annually purchased products containing about 5 million tons of steel and 320 million pounds of rubber - enough to put tires on nearly 6 million automobiles.
>
> They use more petroleum than any other single industry - and more electricity than all the people in industries in Chicago, Detroit, Boston, Baltimore, Houston, and Washington, D.C. combined.

It has been noted by the U.S.D.A. that the innovators of the agricultural community are also the principal purchasers of farm real estate. So too are these larger more progressive producers, the big users of the latest technology, the newest equipment, the larger quantities of fertilizer, and also the experimenters of new breeds, techniques and production methodology.

As the price of labor increases because of higher wage rates, agricultural producers are moving toward

more labor-saving devices. The result is an increased reliance upon more capital expenditures for such equipment. This concept of increasing capital requirements as labor requirements decrease on the farm is examined by an agricultural economist in the *Journal of Farm Economics*.[7]

> Is it possible that withdrawal of labor has forced the producer's attention to labor-saving techniques and to equipment that can be used effectively only with relatively large acreages? As labor becomes scarce and increases in value, operators shift to capital substitutes that can enjoy economies of scale over lower ranges of input. The tractor, for example, permits substantial economies of scale up to a given leval of rate of use per year. To put it to work requires more land. Greater efficiency can be achieved by adding more acres, and part of this economic advantage can be bid into the price of land needed to bring unit cost down. This can lead to an active demand for land, associated with withdrawal of labor. It is possible to conclude that a withdrawal of labor contributes to an increase in the price of land or creates offsetting forces that keep the value of land from falling relative to labor.

A great man once wrote:

No man is an island, entire of itself;
every man is a piece of the continent,
a part of the main; . . . . .[8]

I most respectfully say to you that agriculture is not an "island" unto itself that can or should be blocked off from the infusions of capital so necessary to it; it is a "part of the main" stream of progressive America.

Let us be honest with ourselves. A small ranch can no longer support a family. No return of less than 3% or a loss is going to attract new capital so desperately needed. The farmers and ranchers need a continuation of most of the present provisions of the Internal Revenue Code in the manner I shall indicate.

III. The Farm Loss Problem

I do not say that the provisions of the Internal Revenue Code with respect to farming and ranching should be left as they are. As is so often the case, over the years practices develop that are in essence abuses of the spirit of the Internal Revenue Code and the regulations thereunder. This is true in every area of tax law.

Now in the last few years it has become apparent that some people have gone into the livestock industry solely, or primarily, for the tax advantage. Neither the Livestock Producers Committee, nor any other person that knows the agricultural industry defends these "abuses." So far as I can tell there is no person appearing before this Committee that defends that taxpayer who has been called "a Wall Street cowboy."

Today I speak only for the farmers and ranchers who are engaged in the agricultural business for an economic profit. Naturally there is a problem in distinguishing the legitimate farmer-rancher from those who seek only a "tax profit." As indicated above with respect to capital needs, the fact of non-farm work or income is not an appropriate test. Leaving aside capital requirements, practicality requires a recognition of the fact that, according to the latest census figures, 46% of all farmers and ranchers in the United States reported some days of work off their farms and 32% reported such work amounted to 100 days or more. The importance of non-farm work can be judged from the fact that last year it provided well over half of the

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total income of those farmers with less than $10,000 in farm sales. Even the farmer whose farm sales exceeded $40,000 derived 17% of his income as the result of non-farm work.

These figures demonstrate that whether you are large or small the rancher or farmer has "outside" income in an increasing amount.

In addition, legitimate farmers and ranchers cannot be separated from the "tax profit" investor by the amount of non-farm income test as proposed in essence in H.R. 13270 or by other bills before this Committee. In justification of such test the Ways and Means Committee Report stated that as a taxpayer's adjusted gross income increased, the average size of his loss also increased. This is only to be expected in a normal business operation. All other things being equal, if there is to be a loss, a large business probably in a risk operation will lose more actual dollars than its smaller counterpart.

Yet it is important to note that the same statistics show that the losses represented a smaller percentage of adjusted gross income as the size of the enterprise increased. I have here a chart which illustrates this

(Chart No. 2). For example, farmers and ranchers with adjusted gross incomes of less than $15 thousand had an average net farm loss of over 22% of their adjusted gross incomes. Farmers and ranchers whose adjusted gross incomes were in excess of $100 thousand had net farm losses amounting to about 6% of their adjusted gross incomes.

IV. Statutory Changes Congress Should Adopt

There are certain concrete steps that can be taken by Congress to prevent the "tax profit investor" from utilizing the present law (or at least one interpretation thereof). The Livestock Producers Committee urges your approval of four provisions of H.R. 13270. These are:

1. Extension of the recapture of depreciation provisions to breeding animals.

2. An increase in the holding period for which breeding animals must be held in order to obtain capital gains treatment on their sale.

3. Clarification of the non-applicability of the tax-free exchange provisions of the Internal Revenue Code to exchanges of male and female calves.

4. Recapture on disposition of land improvement costs, which were deducted currently, in the same manner that depreciation is recaptured on depreciable realty.

In my judgment these changes will put a reasonable stop to schemes which derive their profit from offsetting ordinary income deductions with capital gains in those cases where there is no real objective of an economic profit. In other words these steps will eleminate the "tax profit investor."

V. The "Overkill" Provisions

Nevertheless, the Treasury and the Ways and Means Committee have not stopped with these changes, but have gone on to far more radical provisions that will substantially destroy the essential qualities of American agriculture that I outlined above.

Pesticides, for example, although once hailed as the salvation of agricultural industry, are now being severely restricted for possibly causing detrimental affects on human beings through the animals and foods we consume. In our quest to eliminate certain harmful insects, we have gone too far and the benefits previously

praised have now boomeranged and bombarded us with disaster.

So too will be the effect of provisions designed to make farming and ranching undesirable to the so-called "tax farmer" but also unattractive to those who have capital from non-farm sources that could be placed into agricultural enterprises. Care must be taken, not only to protect the small farm and ranch operations, but also the larger ventures that have provided an abundance of food and fiber for the American citizen. We cannot afford to jeopardize the American consumer by artifically and suddenly revolutionizing the economic base of the agricultural industry. As any economist would admit, the institutional influences upon the agricultural economy of the United States are profound. Any drastic changes, therefore, in the institutional perimeters must be carefully analyzed so that their economic impacts are thoroughly understood and that they would be in the long-run beneficial to the general welfare.

H.R. 13270 imposes unique restrictions on the agricultural industry. The House Bill: (1) creates

The Excess Deductions Account concept, (2) singles out farm losses for treatment as a tax preference item under both the Limitation on Tax Preferences and the Allocation of Deductions, and (3) creates a presumption that a ranch is a hobby if its losses exceed $25,000 in any 3 out of 5 years.

Aside from the disastrous rejection of needed capital by these provisions of the Bill, these extremely complex concepts have a further basic difficulty. (The provisions also contain a number of apparent technical deficiencies which are discussed in Exhibit "A" hereto.)

VI. The Obvious Difficulties of the Accounting Problem.

A fundamental difficulty of the "overkill" provisions arises from the use of what the Treasury described as "deviations from good accounting practices." As an example, the Treasury stated that normally in businesses where the production or sale of merchandise is a significant factor, income can be properly reflected only if the costs of the merchandise are deducted in the accounting period in which the income from the sale of that merchandise is realized, i.e., the accrual method of accounting. As a policy of long standing, farmers and ranchers have been permitted

to use the cash accounting method in which such expenses are deducted in full when incurred. The Treasury added that these agricultural provisions "were permitted for farm operations in order to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting." Apparently the Treasury would argue that those farmers and ranchers who have outside income of any substance should be restricted in the use of the cash accounting rules because some of that non-farm income might be offset by the farm losses.

This kind of reasoning will not stand examination. Congress' past approval of the rancher's use of the cash method of accounting does not stem solely from a desire to spare him accounting problems. The most important reason for using the cash method is that under the peculiar nature of the agricultural business, the accrual method of accounting does not yield more accurate results. The typical rancher raises livestock both for sale and for adding to his breeding herd. If it

were possible to always know which animals were destined for which purpose, then it might be possible to make allocations of ranching expenses between animals held for sale and breeding stock so that the accrual method of accounting would give a more accurate picture of income. Unfortunately, the rancher does not know this until many months after the animal is born.

Moreover, many agricultural operators engage in both farming and ranching operations. The difficulty in accurately allocating expenses in such situations has been succinctly summarized by the Attorney General of the United States in a brief recently presented to the United States Supreme Court:

> [T]he nature of farming and ranching operations makes an effective accrual method of accounting difficult to operate. Each employee almost invariably worked on numerous phases of the farm's profit-making endeavors, such as planting and harvesting crops, raising livestock, repairing fences and barns, etc. Thus, it was exceedingly difficult to allocate salaries and the other expenditures among those farming operations.[9]

Frequently there is no way in surveying a farm loss that a farmer or rancher can tell how or in what percentage his loss arose. Yet the penalty provisions

provisions apply. For example, suppose the loss can be allocated to a maize operation; the farmer-rancher loses his capital gain in culling his breeding herd in an equal amount. It is difficult to see any logic whatsoever in such result.

In summary, the provisions of H. R. 13270 require that every substantial farmer or rancher keep his books of account on the strict accrual basis or face the possibilities that a part of his usual deductions will be disallowed and that part of any capital gains he might have in future profitable years will be converted into ordinary income. Yet even if the expert accounting help is available to the farmer or rancher, the Attorney General of the United States has admitted before the U. S. Supreme Court that an "effective accrual method of accounting" is exceedingly difficult "to operate."

VII. Rise in Land Prices

A major complaint raised before the Ways and Means Committee, as to this Bill, as well as by other bills pending before this Committee, is related to higher land prices for the small farmer.

This complaint can be considered only if answers are provided for the three basic questions:

1. Are "tax-profit" farmers really pushing up the price of land?
2. Do high land prices work for or against the bona fide farmer?
3. Do higher farmland values benefit the general public?

If we examine these questions separately and in detail, the results will demonstrate that the complaint is not only, in fact, unfounded, but may be premised on the opposite of the actual situation.

Are "Tax-Profit" Farmers Really Pushing Up the Price of Land?

An analysis completed in 1967 at Texas A & M University dealt with the Texas farm and ranch land market. The authors in their publications state:

"Factors considered relevant to a general analysis of Texas land market activity are per acre price, volume of land sales, size, mineral activity, availability of credit, interest rates, veterans land board activity and land use." [10]

Although the research study devotes considerable time and detail to each of these various influences upon land prices and statistically quantify some of their magnitudes, they no where mention the "tax-profit" farmer as a factor. If, in fact, the "tax-profit" farmer does exert an economic influence upon land prices, it must fall into a long list of other probably more important factors which these economists have readily identified. The study adds:

> "Per Acre Price . . . From 1947-49 to 1965, the relationship between average per acre land price and volume of land sales was that of an inverse correlation, land prices have consistently increased while the volume of sales has declined.
>
> "Size . . . As a result of large tracts of land being divided and sold in smaller units, the median size land sale in many areas of the state has decreased since 1954. Agricultural use of the smaller tracts of land is primarily that of enlargement of existing farms and ranches. The smaller tracts are also being used for part-time farms, rural homesites, status, investment, speculation, and recreation. In this

type of land market, small tracts with a variety of possible uses usually receive a higher per acre price than large units.

"Mineral Activity . . . Mineral rights influence land prices and land market activity in some areas of the state as evidenced by the fact that sellers retained some or all of the mineral rights in 58 percent of the 1965 land transactions.

"Sales Involving Credit . . . The availability of credit is closely associated with the volume of sales. Easy credit encourages sales while a tightening of credit usually results in a decrease in sales volume. For example, in 1960, 50 percent of the total land transactions were mortgaged. In 1963, 73 percent of the total land transactions were mortgaged, and volume of sales increased approximately 27 percent over the 1960 level. Then in 1965, mortgaged sales accounted for only 60 percent of total sales, and volume of sales decreased approximately 40 percent.

"Interest Rates . . . A change in mortgage interest rates could alter the demand for loans and be reflected in land market activity. Decreasing or low interest rates tend to encourage mortgage loans and increase land market activity. Increasing or high interest rates tend to discourage mortgage loans and restrict land market activity.

"Veterans Land Board . . . Since its beginning, the Veterans Land Board has been responsible for 34,500 land transfers involving 2 million acres of land. . . . In the ranching area of Texas, characterized by large land holdings, the Veterans Land Board is inactive. In other areas of diversified land use, characterized by small land holdings, the Veterans Land Board strengthens the demand for land.

"Land Use . . . A change in land use from traditional agriculture to multiple use or to a higher and better use is usually accompanied by an increase in land value. For example, nearly 28 million acres of land used for agricultural production are also leased for wild game hunting. Multiple use of these acres produces income from both sources, and these lands should command a higher price than comparable land deriving income from only one source.

"Many land markets have felt the impact of the urban demand for land. This impact on land market activity has been reflected through increases in land prices. In some counties located near large metropolitan areas, up to 65 percent of the 1965 land transfers involved out-of-county buyers."

The implication in the concept that "tax-profit" farmers and ranchers are forcing land to extremely high levels is based upon the idea that so-called "bona fide" farmers and ranches must pay higher than economically sound prices for it or are not buying at all. It is true that the rate of increase in land prices has been due to active farmer and non-farmer demands. The Economic Research Service of the U. S. Department of Agriculture released a special study entitled <u>Farm Real Estate Market Developments</u> in December 1968. This publication pointed out that

farmers represent nearly 2 out of every 3 buyers of land and have bought this land primarily for the enlargement of their operation. They have, in general, tended to be the more progressive operators in their area. In contrast, the nonfarmers which have purchased land have been in the market for investment and other reasons.

Despite the many different motives for entering into the land market, land values still correlate annual returns to land, the same as average dividend yields do with common stock. Land values have appreciated annually at 5.3%, resulting in a total return of 8.8% per year upon sale. The report, in its summary, concludes with this statement:

> "Although local nonfarm demand will influence future land values in many areas, farm real estate price trends will generally bear close resemblance to the economic health of commercial agriculture."

The following quotations appear in the same article:

> "Farm operators, who make nearly 2 out of every 3 purchases of farmland, generally are buying for farm enlargement. Because of the cost-price squeeze,

increased output is one means of maintaining or increasing future income. Acreage expansion can increase production efficiency, particularly in the short run when adequate machinery and family labor are already available. And as long as these fixed costs remain fairly constant with additional acreage, the farm enlargement buyer may economically justify bidding up prices for an add-on unit.

"Enlargement buyers tend to be the more progressive and efficient farm operators in their community.

"Despite the complexity of market forces, the farmland market, in general, remains sensitive to expected economic returns.

"Although yearly increases in land values need bear no relation to annual returns in the short run, price trends do resemble movements in annual returns over time. For 1958-62, residual returns to land averaged around 3.5 percent of market value. Returns in the 1963-67 period were closer to 4.0 percent. Increases in land values showed a similar annual pattern - 4.4 percent in 1958-62 and 6.6 percent in 1963-68.

"Perhaps the most substantial evidence that land values still depend heavily on agricultural returns is presented by regional data. Variations in rates of return among regions in 1966 and 1967 tended to parallel the regional pattern of land price movements. The Delta region, which has had the Lake States region, second only to Mountain States for the smallest increase in land values for the last 5 years, showed one of the lowest average returns to real estate during 1966 and 1967.

"If past rates of annual appreciation in land prices are considered along with net returns from farm production, the total returns would sufficiently explain the active farmland market of recent years."

This change in value of farmland as it relates more to the productivity of the land is dramatically illustrated by the fact that the major increases in dollar value of farm land have occurred during the last decade in the Delta and the Southeastern States of the United States, the Southern Plains and the Appalachian area. In contrast, some of the smallest gains have been recorded in the Lake States, the Mountain States and in the Corn Belt.

Probably no one statement can better summarize the future of the farmland market than the following paragraph which is taken from the same article:

"Urban influence will increasingly affect rural land markets. Numerous 'mini-booms' will erupt whenever and wherever rapid urbanization occurs. However, even though industrial and population centers are expanding dramatically, an enormous expanse of farmland will remain untouched by urbanization. Consequently, future value trends for land remaining in agricultural use will probably bear close resemblance to the economic health of commercial agriculture, and will continue to be incluenced by national, agricultural, and economic policy."

The proportion of voluntary sales to total farm real estate transfers has increased quite substantially. In 1955, for example, voluntary sales accounted for 70% of all total farm real estate transfers. By 1960, this figure had increased to over 80% and in 1968 was recorded at about 85%. In contrast, estate settlements and foreclosures have moved to much less significant levels. Farmers and ranchers are thus reaping the benefits of the higher land values and are probably carefully considering this land price appreciation in their total income expectations.

In a more recent issue of the "Farm Real Estate Market Development," (March 1969), under a heading entitled Farmers Dominate the Market, it emphasized that farmers made 59% of the purchases in the farmland market during the year ending March 1, 1968. This article stated:

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"... In terms of acreage, active farmers buy 3 acres for every two acres they sell, and therefore are increasing their land holdings.

"Despite dramatic increases in average farm size during the past 2 decades, farmland continues to be bought and sold in relatively small acreages. More than 7 out of 10 transfers in the year ending March 1, 1968, were less than 180 acres.

"Forces on the demand side of the market also encouraged transfer of relatively small tracts -- the most important of these being farm enlargement. Purchases for farm enlargement accounted for 5 percent of sales occurring during the year ending March 1, 1968."

Do High Land Prices Work for or Against the Bona Fide Farmer?

Land is recognized as the principal asset of the American farmer and rancher. According to USDA figures farm real estate represented on March 1, 1968, almost 81% of the total farm assets. Rising farmland values have, of course, forced land into this unique asset position, although it has been the major asset for numerous years. The total value of farm real estate has increased from $130 billion in 1960 to $194 billion in 1968.

This USDA publication emphasizes the extent of bigness already in the industry, that expansion can occur as easily through land rental as purchase, and that the higher land prices provide farmers more credit since land is his principal asset.

The ability of land to serve as a larger credit base which can be used to finance additional land purchases is also brought out by Professor Raup in his article.[11]

Still other concepts of farmland value gains are tied to technological advancement in the society. The following statements are indicative of these ideas:

> "... The evidence, both theoretical and empirical, indicates that the expectation of rising income from technological advance in conjunction with supported farm prices (and from increasing urban demands as well) has been important in contributing to the rise in farmland prices. Expected income increases, because technological advance lowers unit costs and increases individual farm incomes with supported prices, thus providing an incentive to expand farm size, which in turn puts an upward pressure on land prices. Farmland prices rise as many farmers bid for land to capture the gains of technological advance on individual farms thus vanish as the competitive process of acquiring land forces up land prices and absorbs the gains from technological advance.

"But someone gains. The retiring farmer or landowner who sells farmland at an inflated price reaps the benefits of the technological advance. And this process will continue to push up farmland prices as long as farm prices are relatively stable and the march of technological advance continues."[12]

If as some witnesses before the Ways and Means Committee said, the effect of H.R. 13270 will result in lowering farmland prices, the result would be disasterous. As indicated above, many farmers and ranchers have borrowed funds and pledged their lands as collateral. A reduction in farm land prices would almost certainly mean that many outstanding loans based on increased land value would be in jeopardy and could be called under the terms of most loan agreements because of inadequate security. In turn, this could have the adverse compounding effect of causing businesses in local communities dependent upon farming and ranching to close their doors. The trickle of unemployed from rural to urban communities would increase substantially.

The Ad Valorem Tax Base

The property tax payments so important for local and county government programs, including such essential items as schools and roads, also would be in great danger if, some contend, there would (and should) be a decrease in farmland value as a result of enactment of the House Bill. It is inconceivable that the present local governmental functions could continue with a meaningful reduction in the price of land.

During the past 25 years taxes on farm real estate have increased almost five fold; those taxes have gone primarily to support rural schools, which expenditure does not substantially benefit the non-farm resident. Hence, it is important to note that the farmer residing on the farm benefits as to the cost of education of his children (as well as other benefits) from the infusion of outside capital into property purchases.

VIII. The Competition Allegation

Another complaint before the Ways and Means Committee comes from the assertion that the outside

capital creates unfair competition for the "family" ranch. The idea apparently is that the farmowner with non-farm income in high income brackets does not have to depend on farm operations for a livelihood; the high income bracket taxpayer can demand less for his products than the regular farmer, who needs to make a profit to be able to stay in business.

This assertion cannot stand analysis. <u>There is no set of "farm loss" circumstances under which an economic loss produces a more favorable tax result than an economic profit</u>. The greater the economic profit from a farm, the greater overall economic benefit to the farmer or rancher. If the economic profit of the agricultural enterprise can be increased, the farmer or rancher is financially better off, despite the imposition of income taxes on the farm profit, simply because the increased economic profit is never going to be taxed at 100%.

The fallacy of such assertion comes from the premise that a farmer or rancher will sell his product for less than its market value. There is no evidence to support such illogical, unreasonable course of action.

On the contrary, the livestock industry traditionally is one in which the seller gets all he can in a buyer's market.

IX. Summary

In conclusion, there are certain changes I believe should be made in the Internal Revenue Code to eliminate what I call the "tax-profit" operation.

However, the other proposals in the House Bill (Excess Deduction Account, farm losses in the Limitation on Tax Preferences and the Allocation of Deductions and the so-called hobby loss change) would cause at least two disastrous economic changes to the substantial farmer or rancher. These are: (1) the drying-up of new capital so badly needed in agriculture, and (2) chaos from an impossible accounting situation.

As to the farmland price situation and the alleged improper competition, the facts demonstrate that arguments based thereon for this Bill, or others, cannot, in my opinion, be supported.

Gentlemen, while I am grateful for your attention to my remarks, I appreciate even more your consideration of the problems of the American farmer and rancher in light of federal tax laws and the proposals for changes therein.

[1] Although there is a meat import quota, the quota level has never been invoked.

[2] Jack Armstrong, "Cattle and Beef Buying, Selling and Pricing Handbook," Purdue University, May 1968.

[3] Philip M. Raup, "Land Values and Agricultural Income: A Paradox?" Journal of Farm Economics, December 1965.

[4] Gene L. Swackhamer, "Growth of Corporate Farming" Statement before the Colorado Feeder's Association, February 8, 1968.

[5] M. L. Upchurch, "Farming and the Rural Scene--Changes in Organization, Opportunities and Problems." A talk presented at the 45th Annual Agricultural Outlook Conference, Washington, D.C., November 14, 1967.

[6] Orville L. Freeman, "Science for Better Living," Yearbook of Agriculture, U. S. Department of Agriculture, 1968.

[7] Raup, op.cit. note 3.

[8] John Donne, "Devotions No. XVII."

[9] Petitioner's Brief in United States v. Catto, 384 U.S. 102 (1966).

10
F. B. Andrews and Alvin B. Wooten, "Trends in the Texas Ranch and Land Market, Texas Agricultural Experiment Station, B1063, Texas A&M University, April, 1967.

11
Raup, op.cit., note 3.

12
William E. Martin and Gene L. Jefferies, "Relating Ranch Prices and Grazing Permit Values to Ranch Productivity," Journal of Farm Economics, May, 1966.

EXHIBIT "A"
TECHNICAL DEFICIENCIES IN H. R. 13270

1. It is not clear whether the Excess Deductions Account under the proposed Section 1251 can ever have a negative balance. According to subsection (b)(3):

> "If there is any amount in the excess deductions account at the close of any taxable year (determined before any amount is subtracted under this paragraph for such year) there shall be subtracted from the account - (A) an amount equal to the farm net income for such year . . . ."

Thus it would seem that a negative balance is permitted since the year's farm net income could easily exceed the amount in the account.

If a negative balance in the Excess Deductions Account is intended, the proposed Section 1251 does not appear to allow credit (i.e., subtractions) for profitable years prior to the first year of a farm net loss. The proposed Section 1251(a) states that it "shall apply with respect to any taxable year only if - (1) there is a farm net loss for the taxable year or (2) there is a balance in the Excess Deductions Account as of the close of the taxable year after applying subsection (b)(3)(A)."

In the preceding profit years, there is by definition no farm net loss nor is there any balance in the Excess Deductions Account at the close of any of those taxable years. There is no balance in the account because additions to the account are made for farm net losses (which did not arise) and subtractions are made only if there is an amount already in the Excess Deductions Account.

2. Proposed Section 1251(e)(2) defines "farm net loss" as including those special deductions allowable in respect to land under Sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land). When the net farm loss is added to the Excess Deductions Account, it has the effect of adding a portion of these special land expense deductions with respect to the account. The balance in the Excess Deductions Account will affect the character of gain on sale or exchange of land only to the extent of the land's "potential gain." Proposed Section 1251(c)(2)(C). If no deductions under Sections 175 or 182 have been taken with respect to the land within 5 years, the

"potential gain" in the land is zero (Proposed Section 1251(e)(5)) and thus any gain attributable to those expenses will never be recaptured. Yet such conservation and clearing deductions will remain in the Excess Deductions Account and will convert the capital gain on the sale of some other asset which is totally unrelated to the land, such as breeding stock, into ordinary income.

3. Proposed Section 1251(b)(5)(B) provides that upon the gift of farm recapture property the donor's Excess Deductions Account is transferred to the donee if the potential gain on the farm recapture property given in any one year period exceeds 80% of the potential gain on farm recapture property held by the donor immediately prior to the first of such gifts. This rule appears to lead to unintended hardships for the uninitiated and to be of little effectiveness for the careful planner.

If, for example, a rancher should give half of his ranch (and presumably one-half of the farm recapture property and one-half of the potential gain thereon) to one son, the donee would not be required to take any of

his father's Excess Deductions Account. If more than 12 months later, the rancher gave a second son the remainder of the ranch, that donee would be required to take his father's entire Excess Deductions Account. With careful planning, however, the strictures seem easily avoided. For example, a farmer could give his son an undivided 80% interest in the farm without causing a transfer of his Excess Deductions Account. Twelve months and a day later, he could give the son another undivided 16% (being 80% of the remaining 20% of the original farm). At this point he will have transferred approximately 96% of the original farm without a transfer of the Excess Deductions Account. By waiting another 12 months and a day, the remaining 4% of the original farm could be given to a charitable organization who would then succeed to the entire Excess Deductions Account. The farmer could then again take up farming with no balance in his Excess Deductions Account and the son would have received 96% of the original farm with no transfer of the account.

4. The proposed Section 1251(d)(6) provides

that in certain transfers of farm recapture property to corporations, the "stock received by a transferor in the exchange shall be farm recapture property." Securities received in the exchange are not so treated. This permits the avoidance of the Excess Deductions Account rules by careful planning. The farm recapture property can be transferred to a corporation for all of its stock and bonds equal to almost all of the value of the transferred property. Such an exchange generally will be tax free under Section 351 of the Internal Revenue Code. The bonds (i.e., "securities") can then be sold and none of the gain thereon would be affected by the balance in the Excess Deductions Account because the bonds are not farm recapture property.

5. The depreciation which contributed to a taxpayer's farm net loss will be included in addition to the Excess Deductions Account. When that depreciable property is sold, the gain equal to that depreciation will be recaptured and treated as ordinary income under the provisions of Section 1245 of

the Internal Revenue Code. Since the tax benefits arising from the depreciation deduction will have been totally eliminated by the sale, there appears to be no reason to leave any of that depreciation deduction in the Excess Deductions Account where it will reduce the amount of capital gains on the sale of some other asset. The depreciation deduction ought not to be recaptured twice.

PRICES PAID AND PRICES RECEIVED BY FARMERS

ANNUAL, U. S.

(INDEX NUMBERS 1957-59=100)

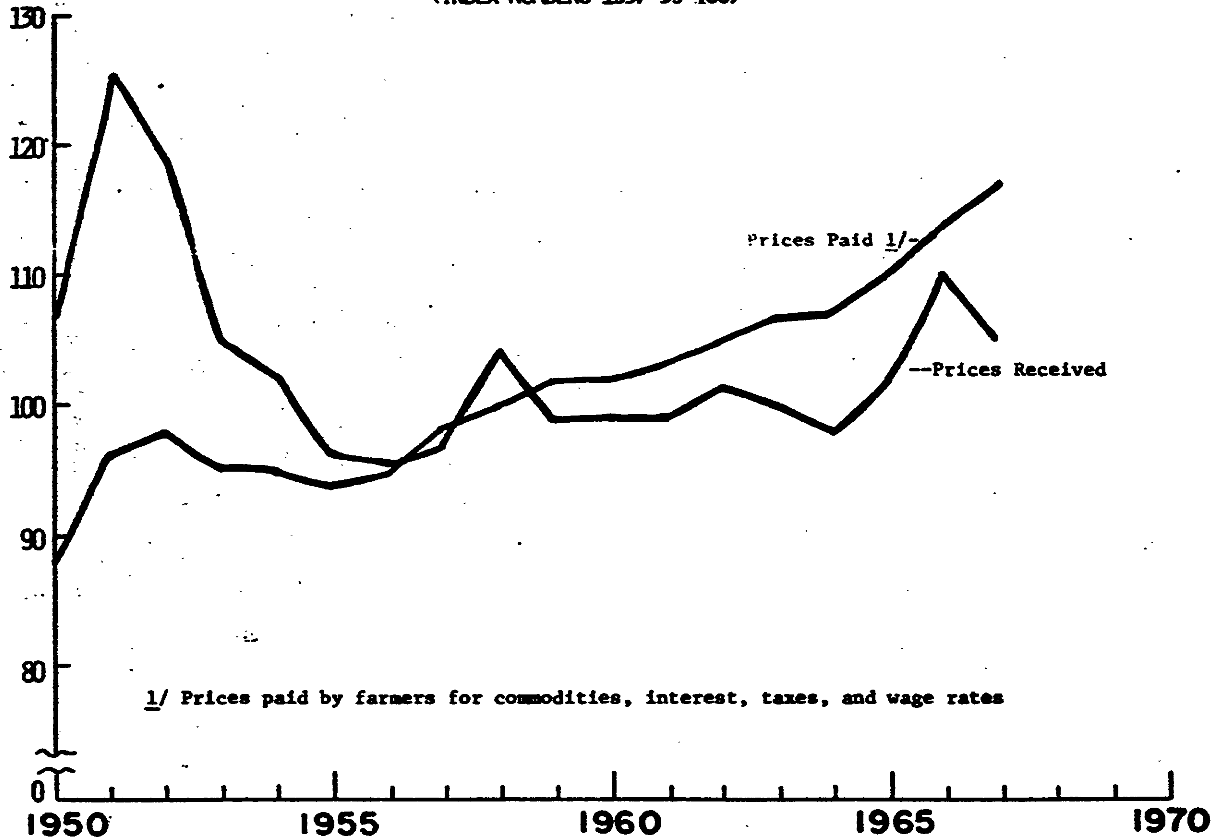

CHART 1

NET FARM LOSS AS A PERCENTAGE OF AGI CLASS (THOUSANDS)

(1964-1966 AVERAGE)

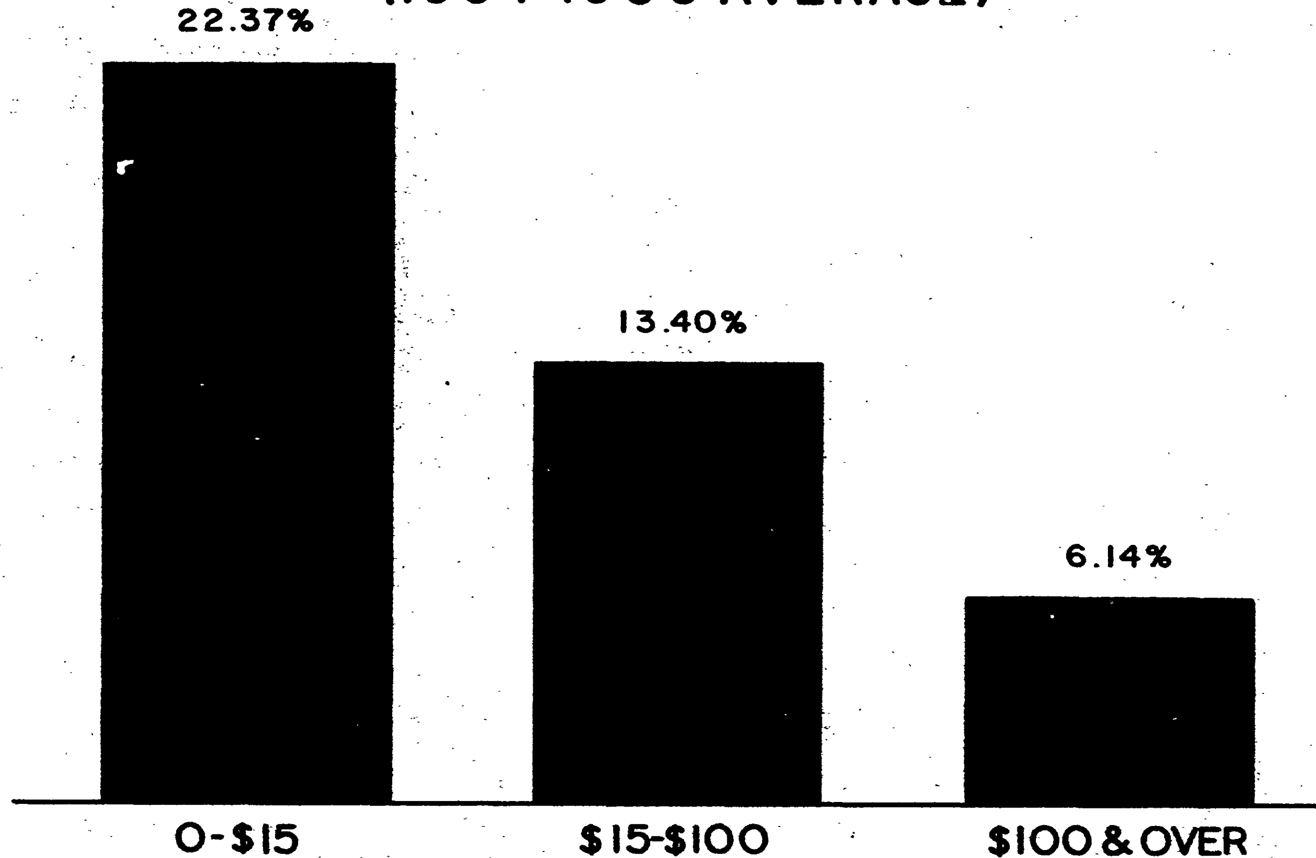

CHART 2

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STATEMENT OF GENERAL EARL RUDDER
COLLEGE STATION, TEXAS

WITH RESPECT TO H. R. 13270

Introduction

Gentlemen, while I am the President of the Texas A&M University System, I am also a cattleman, a native of the Southwest, and an individual quite familiar with the problems currently being experienced by agricultural producers of this area of the Nation. Although it would be difficult for me to refrain from the inclusion of some academic material pertinent to the situation, this testimony is offered to you primarily from the viewpoint of these latter positions.

I have been concerned about those individuals who have ranches or farms but apparently intend only to have some type of "tax profit." Certainly no one can defend such individuals as a matter of equity

because it is readily recognized that they would, in fact, have some distorting affect upon the agricultural economy. I am here to try to put the problem into its proper perspective. Certainly some congressional action is warranted, but we should not have the severe economic upheaval due to "over-kill" provisions.

Care must be taken, not only to protect the small farm and ranch operations, but also the larger operations that have provided economical food for the American citizen.

Let us first examine the make-up of the modern American farmer and rancher, the plight he is currently facing, and the benefits which have accrued to the American consumer under the current framework of agriculture which has developed.

The Modern Farmer and Rancher

In order to better understand the type of

agricultural environment in which we are currently operating, let's briefly look at the farmer and rancher of the 1960's. Today's average farmer or rancher is 51.3 years of age, has an average household size of 3.6 persons and has lived on his farm for over 15 years. He has completed 4 years of high school, operates a 351.6 acre farm which has a value of close to $51 thousand, and works about 79 days off the farm each year.[1]

Governor Connally has mentioned the "outside" work and income of the farmer or rancher. I would like to develop this topic further. This work outside of the farm is quite interesting, in that it has become a way of life for most farm families. For example, according to the latest census, 46% of all farm operators in the United States reported some days of work off their farms and 32% reported such work amounted to 100 days or more. There is a significant regional difference in this

proportion too. Almost one-half of the farm operators in the Western region of the country reported some off-farm work while this proportion was 49% in the South and 43% in the North. Of all farm operators working off their farms, 69% reported working 100 days or more, and 56% reported working 200 days or more. In the West, 62% of the operators reporting work off farms, worked 200 days or more, whereas, in the North only 52% reported 200 days or more.

As might be expected, the proportion of farm operators working off the farm and the number of days that they worked varied according to the age of the operators. Sixty-three percent of the operators under 35 years of age reported working off their farms, while 54% of the operators in the 45 to 54 age bracket showed off-the-farm work. In essence, this data merely emphasizes the fact that the modern day farm operator spends a considerably larger proportion of his time working off-the-farm than most people realize.

Not only is off-farm work important in a time aspect - it represents an important source of income to such farmers (Figure 1). In the latest issue of the Farm Income Situation released by the U. S. Department of Agriculture, some rather interesting information is offered regarding net income realized on farms versus off-farm income. The report shows, for example, that in 1968, operations which had less than $2,500 farm sales reported, 85% of the total income of the farm operator's family came from off-the-farm sources. The larger size classifications of farms, those with less than $10,000 farm sales during the year, relied somewhat less upon off-farm income, actually 53% of their total income. Moving to the largest category of farms, those with $40,000 sales or more, off-farm income contributed only 17% to the total farm operator's family income. (See accompanying Tables 1, 2 and 3)

In addition to off-farm part-time employment, supplemental returns from land-based activities such as hunting, fishing, and oil leases contribute significantly to the bona fide farmer or rancher's total family income.

Such activities, to most rural residents, are considered as a part of farm income, although there is a distinction among them for tax purposes. Strangely enough, limitations placed upon the farmers and ranchers with regard to outside income is in direct opposition to the U. S. Department of Agriculture goals and expenditures aimed at stimulating such supplemental income.

In the Yearbook of Agriculture for 1968, Science for Better Living, Secretary Freeman made this statement with regard to non-farm income:

> "Working closely with farmers and other rural people, the U. S. Department of Agriculture is helping to stimulate a rural renaissance.
>
> "Private enterprise is being attracted to the countryside. Rural people, both farm and nonfarm, are taking advantage of government supported opportunities to establish part-time businesses or trades.

"On thousands of farms, picnic and camp sites, riding stables, game and fishing preserves, winter and water sports facilities have become supplementary and even primary sources of income."

Since agriculture is a highly variable income source, fluctuating with economic conditions in the nation as well as climatic changes, it is also a business enterprise which has tremendous variations in profitability. Net income can sometimes occur, but net deficits are as equally likely. Whenever farm losses do occur, it is obviously to the benefit of the farmer or rancher to use such loss to offset any non-farm income; indeed it is imperative in many cases.

Beef Consumption and Retail Prices

Because of increased production, the development of the commercial cattle feeding industry, and increased efficiency throughout the production and

feeding levels of the cattle industry, beef production in the United States increased from approximately 13 1/2 billion pounds in 1955 to almost 21 billion pounds in 1968. Consumer demands also increased substantially during this period so that per capita consumption was able to increase from 82 pounds per person in 1955 to 109 pounds per person in 1968 without

(the remainder of this page was intentionally omitted.)

any major change in price levels. Some of this increased demand exhibited by the consumer was a result of increased disposable income, although a substantial proportion of it was due to the drastically reduced consumption of other red meats. In fact, during this entire period when beef consumption per person increased 27 pounds, the retail price level for beef showed an increase of only 20 cents per pound. (Figure 2)

Despite this substantial increase in quantity, a rise in beef quality, and almost constantly increasing costs of production, the American consumer has been blessed with an average retail price only slightly higher than that which existed in the mid-1950's. Even a large proportion of this small increase can be traced to the increased demands for consumer services at the retail level in the form of packaging, closer trimming, boning, etc.

Although today's consumers are appalled by the relatively high prices of beef in the retail counter, much of the criticism is really focused at the levels

for the so-called "high-price beef cuts." Unfortunately, all of a beef carcass is not composed of high-price cuts and many "low-price cuts" are often ignored by the consumer picketers. We must remember that only about a quarter of the total beef carcass yields steaks, another quarter roasts, a third quarter miscellaneous cuts such as hamburger, stew meat, etc. and the final quarter of the carcass is lost through shrinkage, cutting loss, and trimmed fat and bones.

Let's spend a minute examining these retail beef prices that have excited some housewives. The United States Department of Agriculture bases its average retail price for beef on prices collected by the Bureau of Labor Statistics. These are basically gathered for use in preparing the consumer price index. The Bureau's purpose is to measure changes in food prices, rather than their absolute levels. Even though the Bureau goes to considerable lengths to obtain a good sample of cities and types of stores in which to gather these prices, the data really offers severe problems for the Department of

Agriculture in that it does not take price specials properly into account.

For example, the advertised price specials that are usually offered on Thursday, Friday and Saturday represent the majority of the retail food sales. Red meat and poultry are the most frequently used items on such sales since they attract people into the store. When the retailer puts a certain cut of beef or broilers on sale during the weekend, the volume of the products sold at these reduced prices is often several times the volume sold at regular prices. Unfortunately, the Bureau of Labor Statistics collects retail food prices on Tuesday, Wednesday and Thursday of the enumeration week, and does not weigh the prices of food according to the specials to reflect this increased volume sold. The average prices reported by the Bureau, therefore, overstate the true average prices of foods. The National Commission on Food Marketing emphasized this error and worked with the Department of Agriculture in an attempt to revise retail prices for red meats and

poultry in recognition of this problem. In the year 1964, for example, the retail value of Choice beef was reduced 7 cents per pound, for Choice lamb 3.6 cents per pound, for pork 4.1 cents, and for veal 3.8 cents per pound. No data are available with which to compute revised retail prices back into the 1950's, but it can be assumed that there is an overstatement of retail prices occurring back as far as 10 or 15 years. Apparently, however, the use of price specials in supermarkets has increased in the more recent years, so it seems likely that the overstatement is probably greater in the 1960's than it was in the mid-1950's.

Even when this overstatement of the retail prices is ignored, the retail price for beef has shown very little rise during the last 10 to 15 years. (Figure 3) Beef, of course, means cattle, and the prices of high quality fed cattle have reflected about the same basic type of price pattern as the retail beef cuts. The typical rancher, however, does not produce beef, but rather, feeder

calves, that today move into a highly merchandized and specialized cattle feeding industry. This cow-calf producer's output is calves, and they are his only major source of income. Prices received by farmers and ranchers for calves, however, during the last 20 year period have been hardly encouraging.

Texas cattlemen, for example, received an average of $26.27 per hundredweight for live calves in 1968. This represented the highest return from calves, with the exception of the record established in 1951, when prices reached over $30 per hundredweight. (Figure 4) Price levels for calves in Texas have remained within a relatively narrow range ever since the latter 1950's, even though as we have indicated earlier, the costs involved in producing such calves has increased at about the same rate as inflation.

The question, of course, is how can cattle producers pay more for the inputs to produce beef, yet still sell the commodity at relatively the same or even lower levels. The answer to this, of course,

is that they cannot, at least not without losing money. A recent Texas A&M University study indicated, for example, that in order to attain a $3,000 a year return to labor and mangement, it would require an average annual investment of about $4,900 in hog production, about $21,000 for broilers, $48,000 in dairy, and a healthy $112,000 investment to get a $3,100 income from the cattle business.[3]

Similarly low returns were found through a research study of costs of western livestock ranches by the U. S. Department of Agriculture.[4] This analysis deals with actual commercial cow-calf ranches in the Northern Plains, Northern Rocky Mountains, and Southwestern areas of the country, during 1967 and 1968. Returns for the Southwestern ranches were consistently lower and yielded about a $6,000 to $7,000 total return to operator labor, management and capital with a $212,000 to $220,000 total ranch investment. Certainly, the investment attractiveness of such a cow-calf enterprise would be quite dubious to a businessman considering this field of endeavor.

According to the 1964 Census of Agriculture, there were about 2.3 million farms and ranches in the United States that reported having cattle and calves. Of that total, however, about 1.3 million reported maintaining beef cows while another 1 million were farms that had no cows other than milk cows or dairy type. Let's now examine these 1.3 million farms and ranches. It is assumed that, since these operations maintain beef cows, they are in the business of raising beef calves. The Census shows us, however, that of these 1.3 million cattle operations, 69% had less than 30 head and there were, in fact, only 3,645 farms in the entire United States that had 500 head of beef cows or more. Of this total a mere 1,010 farms in the whole country had 1,000 head of beef cows or more. (Table 4)

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Table 4- Numbers of Cattle and Calf Farms and Ranches

1964 Census	Number of Farms
Farms with Cattle and Calves	2,283,881
Farms with no cows other than milk cows	959,969
Farms with beef cows	1,323,912

Of the 1.3 million farms with beef cows

-69% had less than 30 head

-only 3,645 farms had 500 head or more

-just 1,010 farms had 1,000 head or more

Expectations for Profit

At this point one should examine the concept of expectations of profits on the assumption all legitimate farmers and ranchers have this attitude.

In the recent Ways and Means Committee report on this Bill, there was a reference to data which indicated that there was a strong trend toward losses increasing as the taxpayers adjusted gross income increases.

Actually, how profitable is the cattle business? Should one really expect huge profits or substantial losses? According to data collected by agricultural

economists at Texas A&M University, it costs an average of about $90.50 to raise a calf, or keep a cow for a year in Texas, if all costs are considered.

This composite average costs is obtained by totaling the various expenses involved in maintaining a cow for one year.[5] (Table 5)

Table 5 - Costs of Keeping A Cow For One Year

Expense	Amount
Land Charge*	$ 28.70
Depreciation	5.60
Interest-herd capital**	10.70
Replacement cost	5.55
Operating costs	39.95
Total	$ 90.50

*Land cost based upon fair lease or rental value.

**Considers cow cost and a portion of the bull.

Note: No charge for labor or management is included.

Let's now look at the returns Texas ranchers probably received during the Report's test year - 1966.

In that year, the Texas calf crop averaged 84%, the average price received for calves was $24.60 per hundredweight and the estimated weaning weight for calves ranged between 350 and 400 pounds. Assuming that our typical cattleman in Texas during 1966 produced a 400 pound calf, sold it for $24.60 per hundredweight, and had an 84% calf crop. Under these conditions, the return per cow would be $82.66. Since our cost estimates, however, were $90.50 per cow, this left the rancher with a net loss of $7.84 per cow during the year.

It is easy to see with these figures that the larger the herd size, the larger the loss would be on any particular operation. Although there may be some economics of scale involved, they are not sufficient enough to change these basic cost figures very substantially. The loss recorded, therefore, of $7.84 per cow during 1966 would mean a $78.40 loss for a 10 cow operation, a $7,840 loss for a 100 cow operation, and a $78,400 loss for a 1,000 cow operation. Thus, our analysis of probable costs

and returns of Texas ranchers in 1966 yields exactly the same type of average loss-size operation relationship as the Report figures. A similar computation of the 1967 statistics indicates that the average Texas rancher realized a net loss of only $4.50 per cow during that year, a substantially better return situation, but still recording a loss.

These loss situations are more common to the cattle businesses of the Southwestern part of the United States. A recent U. S. Department of Agriculture report shows that cattle ranches which operated in the Southwestern part of the United States during the period 1963 to 1967 had considerably higher operating expenses per unit of production than did similar types of ranches in the Northern Plains and the Northern Rocky Mountain region. These operating expenses averaged 25% higher in the Southwest, so that it is more likely for difficulties to arise in maintaining profitable operations in that section of the country than in the other. Also adding to this less favorable

cost situation is a generally lower livestock price level in the South, and consequently smaller returns.

Expectation, according to Webster, is the prospect of the future. Unfortunately, cattlemen are not noted for their ability as fortune tellers. Even the feeding of cattle is highly speculative and very unpredictable. It is not uncommon to experience severe losses for one, two, or even five years in a row and then do much better for the next five. Most of these unprofitable periods are usually felt when the margin between the price paid for feeders and the price received for finished cattle, falls below zero. (Figure 5)

Agriculture, and particularly livestock production, is a highly risky and variable income generator. Not only is the farmer and rancher subject to the elements of nature, but he is also tremendously affected by national situations, economic crises, government programs, and the whims of the American consumer and her demands. No other segment of the economy involves such a wide array of risk and uncertainty, yet at the same time, offers both a short, as well as hazy, planning horizon.

Agriculture Needs Outside Capital for Research

Governor Connally has referred to some of the reasons for the necessity of outside capital. I want to touch on some aspects of the use of capital in agriculture.

It has not been more than about 40 years since agricultural producers of the United States struggled with primitive tools behind a mule to scratch the surface of the earth. The scientific and technological progress of our agriculture has been so rapid that few of us recognize that back in 1937, it required one person employed in agriculture to provide enough food and fiber for 10 persons in the Nation. Yet, by 1967, just 30 years later, one farmer or rancher produced abundantly for more than 40 persons.

No agricultural commodity has shown more progress than that of livestock, particularly cattle production. The first Hereford bull imported in 1817 by the distinguished American statesman, Henry Clay, bears little resemblance to the modern breed of Hereford cattle so prevalent in our country today. Similarly, the first Shorthorn cattle imported in 1783, the original Brahman

stock in 1853, and the initial Angus importations in 1873, held the basic seeds of new breed developments in the United States. Many of these original cattle are hard to identify when reviewing the currently accepted standards of these breeds. Throughout the years since their importation, they have been bred, crossed, and recrossed and now yield superior animals designed to reproduce effectively, gain weight efficiently, and yield carcasses with a high proportion of trimmed retail cuts.

It has been through the efforts of the Agricultural Experiment Stations at land grant institutions such as Texas A & M University, and the U. S. Department of Agriculture that the basic research and extension work was performed. But more than that, it was the brave and industrious cattleman of yesterday using applied research in their own herds who have developed livestock to the point where it now yields more meat, at a reduced cost, with less land, and less manpower than ever in history.

Agricultural research contributions have been

tremendous, particularly when you consider the small amounts of funds devoted to it in relation to other research investments. During 1966, for example, the total agricultural research expenditures by the U. S. Department of Agriculture and the State Agricultural Experiment Stations was $331 million. Industry contributions to agricultural research in that same year were $473 million. Of course, we are talking here about total agricultural research spending, not just research for livestock or cattle. Some idea of the small amount of expenditures devoted exclusively to, say, beef cattle research can be obtained from these comparisons. In 1966, the total budget outlay for the U. S. Department of Agriculture was $5.9 billion, of which only $167 million was spent for research. Beef cattle and related research work, including such things as consumer acceptance, control of insect pests, and economic efficiency in marketing represented only $10.3 million of this total. Another $18.1 million were spent by all the State Agricultural Experiment Stations on beef cattle research, bringing the national

total to only $28.5 million.[6]

At first glance, this figure looks high, but compare it with the research and development expenditures of 1968 for some major corporations: IBM - $410 million; Texas Instruments - $130 million; Xerox - $76.8 million; and Merck - $55.4 million.[7]

Such public research spending is frequently, however, not all that is required. For example, the screwworm infestation of the Southwest was attacked directly by livestock producers who contributed a total of $4 million to help research efforts to erradicate this economically important pest. Recognizing the concern of the producers and encouraged by their financial backing of the project, the government came to the aid of the program with additional funds and assistance. As an administrator at Texas A&M University, I can assure you that contributions to our research efforts are frequently made by producers and often represent the final financial push required for success. Such research contributions by private individuals are usually from the more affluent farmers and ranchers, the ones that can afford such generosity.

An economic study performed in California indicated that not only has such financial support of agricultural research by private groups and individuals been substantial, but that the time lag between the initial phases of the project and the actual accomplishment of the technological advancement, has been shortened considerably through the use of these additional funds:[8]

> Much of the work performed in agricultural experiment stations is subsidized by either industry or government. Research on minor crops may well lag behind other research programs unless some minumum industry support is received to enable purchase of needed equipment, materials and labor inputs.
>
> It would appear logical that given agricultural experiment station research with the minimum backing, then mechanization will be developed sooner or later regardless of industry financial support. At this point, the industry interest is then one of assuring the "sooner" development rather than the "later." Additional financial support would be directed at compressing the probability function to the left, or increasing the probability that the research success would be achieved in a certain number of years or less.

It would be easy for me to claim, at this point, that all the spectacular advancements made in agricultural productivity have been solely due to the university

and government achievements, but this would not recognize the major stumbling block to technological progress - adoption of new technology. Scientists at the institutions and in the research laboratories can experiment and evolve new concepts, techniques and improved varieties. Our extension services then must take this new information out into the field to the producer and show him how to use it. But it requires the cooperation, the field testing, the sacrificing in time and money of the farmer and rancher that produces results and finally develops the new breeds and the modern types. During last year, for example, the Texas Agricultural Extension Service had the cooperative efforts of producers on 4,486 different field demonstrations, of which 1,283 dealt directly with livestock, breeding or feeding.

Agriculture Needs Outside Capital for Development and Expansion

Agriculture is not a self-supporting industry. It requires huge quantities of capital, particularly when we consider the amounts needed to build up a breeding herd or to develop an improved crossbreed.

Fortunately, for us, the tremendous sums of capital required to experiment with new breeds and types has been available in the United States. In many foreign countries, for example, the government is relegated this chore because of the expense and the poor returns on investment. Our livestock producers have been blessed with a realistic Congress which, many years ago, provided some measure of relief for such individuals through somewhat less stringent accounting procedures. The result has been a livestock development in this Nation that far exceeds any other country in the world.

This requirement for high quantities of capital in cattle breed development is emphasized in the Yearbook of Agriculture 1968, issued by the U. S. Department of Agriculture. In a discussion of hybrid vigor and how this was used by corn breeders and later chicken and swine breeders, the author states:

> . . . But cattlemen did not follow their lead immediately.
>
> One good reason for this lag was that cattle breeding stock represents a high investment because much time passes before a new generation reaches breeding

age. So, it is quite expensive to experiment with new cattle breeding systems.

Yet, this did not discourage livestock producers and today United States beef cattle are among the world's most desired types. This expanded size of the market for beef breeding herds has added a new dimension to the capital problem. As Governor Connally has said, the United States is now a major exporter of beef breeding cattle. This exportation of beef breeding cattle offers an extremely favorable situation for the United States, in that it represents a commodity that is exported for cash, and does not have to be subsidized under any direct government program. At the same time, the good will established with these developing countries seems to be far more lasting than that produced with any other agricultural export, probably because such animals really represent years of research and development. Secretary of Agriculture, Orville L. Freeman wrote in The Yearbook of Agriculture 1968:

> But American agriculture is also the world's biggest "storehouse" and research "factory" for agricultural knowledge. Exporting this knowledge to improve farm production in food-short countries can contribute immensely to world stability and peace - and to the eventual entry of the entire free world into the age of abundance.

Governor Connally mentioned that the innovators of the agricultural community are the utilizers of the latest technological developments, the experimenters of new breeds, and the land developers. Land clearing, stock pond establishment brush control and similar methods of increasing the efficient use of the land are sound management practices for the progressive manager.

The serious consideration here is the diametrically opposed positions which seem to be evolving in the different branches of the government. During 1967 alone, for example, $7 million was spent by the USDA in cost-sharing brush control work with farmers and ranchers of this country. In that same year, slightly over $14 million were expended on cost-sharing stock pond and agricultural reservoir construction. For another branch of the government to now contest, in effect, the legitimacy

of these expenditures as a deduction, seems quite inconsistent. Certainly, such improvements add to the productivity of the land and probably to its net worth, but unfortunately in some isolated cases the value is actually decreased since the recreational value is lowered. Likewise land which is left unattended or overgrazed, can easily be lost to brush and erosion, thus lowering its productive value.

The Budget of the United States Government

Fiscal Year 1969 eloquently states the purpose of these cost-sharing programs in this passage:

> This program is designed to encourage conservation by sharing with farmers, ranchers, and woodland owners the cost of carrying out approved soil-building and soil-and water-conserving practices. These are practices which farmers generally would not perform to the needed extent with their own resources. The rate of cost-sharing averages about 50% of the cost. Cost-sharing may be in the form of conservation materials and services or a payment after completion of the practice.
>
> Conservation measures offered include those primarily designed to establish permanent protective cover, improve and protect established vegetative cover, conserve and dispose of water, establish temporary vegetative cover,

temporarily protect soil from wind
and water erosion, and provide wild-
life and beautification benefits.

These programs are designed to give technical assistance and aid the conservation operations of the Soil Conservation Service. During the fiscal year 1969, budget recommendations for these services were $203 million. Throughout the federal budget recommendations it is repeatedly emphasized that such cost-sharing assistance is necessary to continue the long term practices that prevent irreparable damage to land resources and that would not be applied if it were not for federal assistance.

If any doubt still exists that agriculture requires outside capital, it can be dispelled by the recognition that even the government has found it necessary to provide funds to agriculture through several major rural programs:[9]

The Administration conducts two capital
investment programs: (a) the rural
electrification program to provide
electric service to farms and other
rural establishments; and (b) the
rural telephone program to furnish
and improve the telephone service in

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rural areas. Funds for making repayable loans are borrowed from the Secretary of the Treasury.

1. Rural electrification.--This capital investment program is financed through loans which bear 2% interest and must be repaid within a period not to exceed 35 years. Loans are also made for shorter periods at 2% interest to electrification borrowers to be reloaned to their consumers for the purpose of financing the wiring of premises and the acquisition and installation of electrical and plumbing appliances and equipment, including machinery.

2. Rural telephone.--This capital investment program is financed through loans which are made for the purpose of financing the improvement, expansion, construction, acquisition, and operation of the telephone lines and facilities or systems to furnish and improve telephone service in rural areas. The loans bear 2% interest and must be repaid within a period not to exceed 35 years.

Financing farming and rural housing.--Loans of the Farm Credit Administration through the Federal intermediate credit banks for cooperatives are primarily to help finance agricultural production and marketing.

These extremely low rates of interest, and long payment periods provided by government lending emphasized that capital for such agricultural development is not really available even from outside sources.

Summary

Agriculture, in the United States today, is dynamic and growing. In my own State, Texas, agriculture provided the market with almost $3 billion worth of products, during the past year. Except for crude oil and gas, agriculture brings to the State its largest source of income.

This agricultural growth, however, has not just happened. It was a result of a number of significant factors - development of new technology, education and promotion, the action programs of both the Federal and State Departments of Agriculture, availability of resources, and farmers and ranchers willing to adopt new practices. If agriculture is to remain strong, however, it must be guided through new treacherous cross currents - those of growing cities, shrinking resources, the continued price-cost squeeze, and general indifference from the urban-oriented society which it services.

The preliminary Texas water plan, for example, indicates that by 1980, 4 1/2 million acres of cropland, about 3 million acres of which is highly fertile,

will be removed from productive use. Most of this will be land destined to become water reservoirs to service the needs of the rapidly growing population centers as well as agriculture and the remaining million and a half acres will be required for urban development, highways, airports, etc. Our principal resource for agricultural production - land, is becoming scarce.

Our Texas Agricultural Experiment Station operates throughout the State. By virtue of its assigned responsibilities, it represents the focal point of coordination for all agricultural research in the entire State. It is important that this knowledge base be maintained in order to stimulate further agricultural development. Such efforts, however, must be supported by a massive, continuous research, education and extension program - a program combining all the diversified and interdependent strengths of the scientific team expertise that we can muster.

But, the Experiment Station, the Extension Service and the entire University cannot succeed without the efforts and assistance of the dedicated individuals

with the will and desire to try "a new idea." These innovators already realize that it may not lead to glory, nor riches, nor even maybe compensation - only self satisfaction that they have contributed.

Texas A&M University stands ready through its basic team to help meet this formidable and challenging task. Gentlemen, we ask not for your praise, but only for your cooperation in this effort.

[1] This data from 1964 Census of Agriculture, U. S. Department of Commerce.

[2] Gene L. Swackhamer, "The Growth of Corporate Farming," Statement before the Colorado Cattle Feeders Association on February 8, 1968.

[3] Tom E. Prater. "Investment Requirements for an Approximate $3,000 Return to Labor-Management," Texas Agricultural Extension Service, Texas A&M University.

[4] Wylie Goodsell and others, Costs and Returns Western Livestock Ranches, 1968, USDA, July 1969.

[5] Tom E. Prater. "Estimates on Annual Beef Cow Cost by Areas," Texas Agricultural Extension Service, Texas A&M University.

[6] A National Program of Research for Agriculture, Joint publication of the Association of State University and Land Grant Colleges and the U. S. Department of Agriculture.

[7] Value Line Selection and Opinion, Vol. XXIV, No. 44, Part 11, August 15, 1969.

[8] Samuel H. Logan, "Evaluating Financial Support of Research Programs," Journal of Farm Economics, February 1964.

[9] The Budget of the United States Government - Fiscal Year 1969.

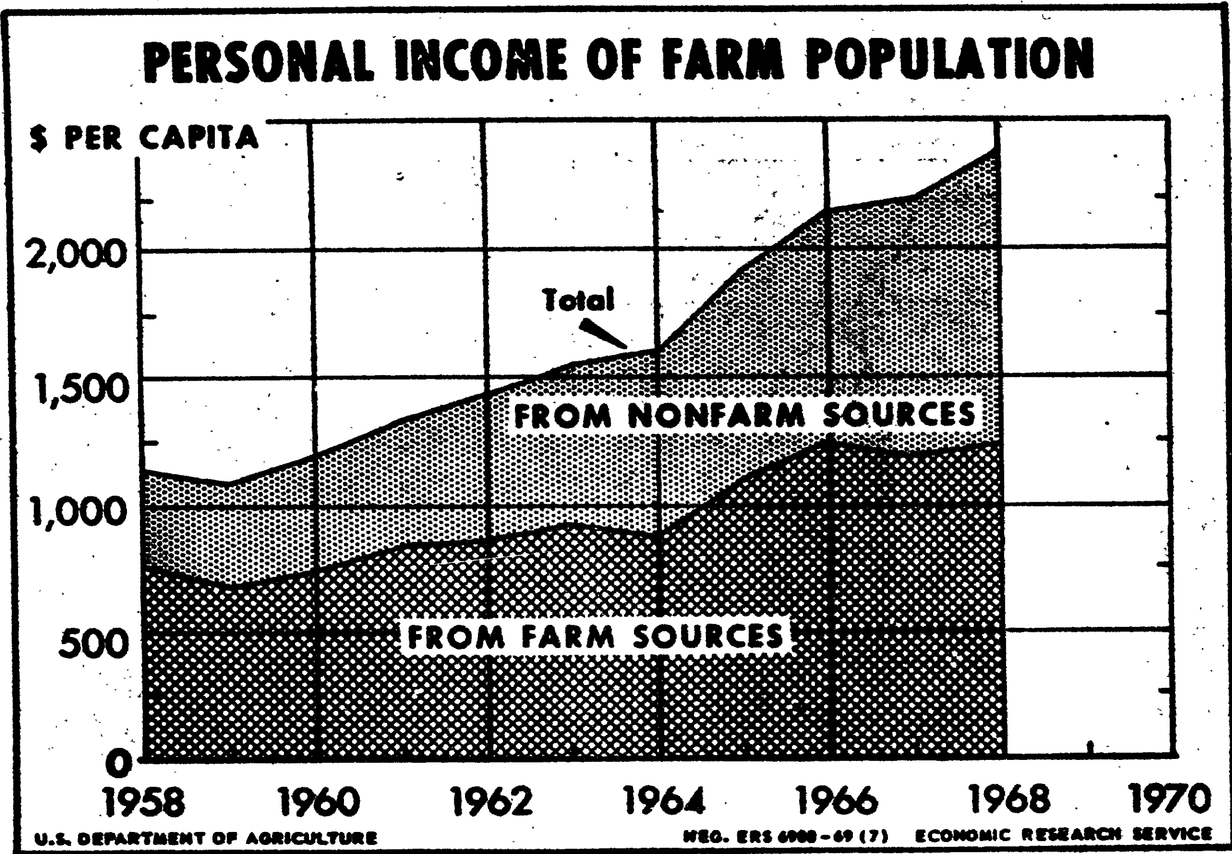


Figure 1

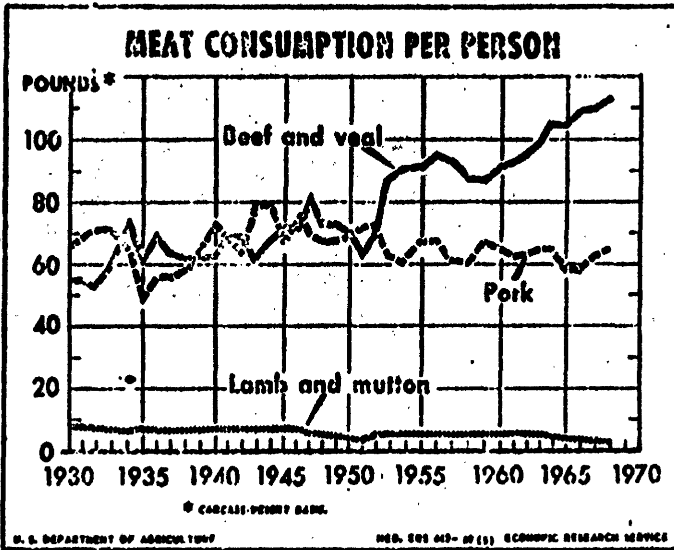


FIGURE 2

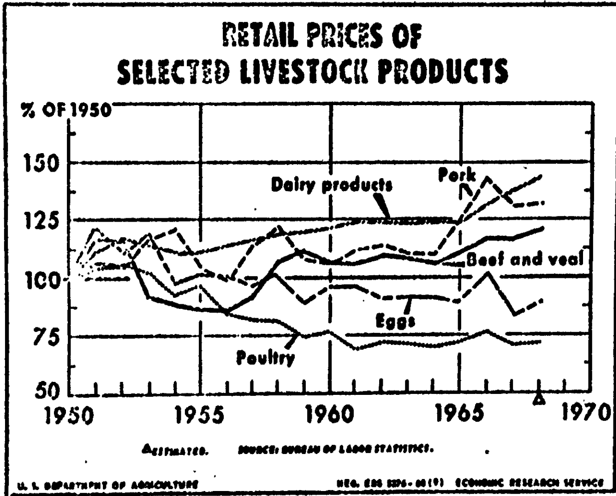
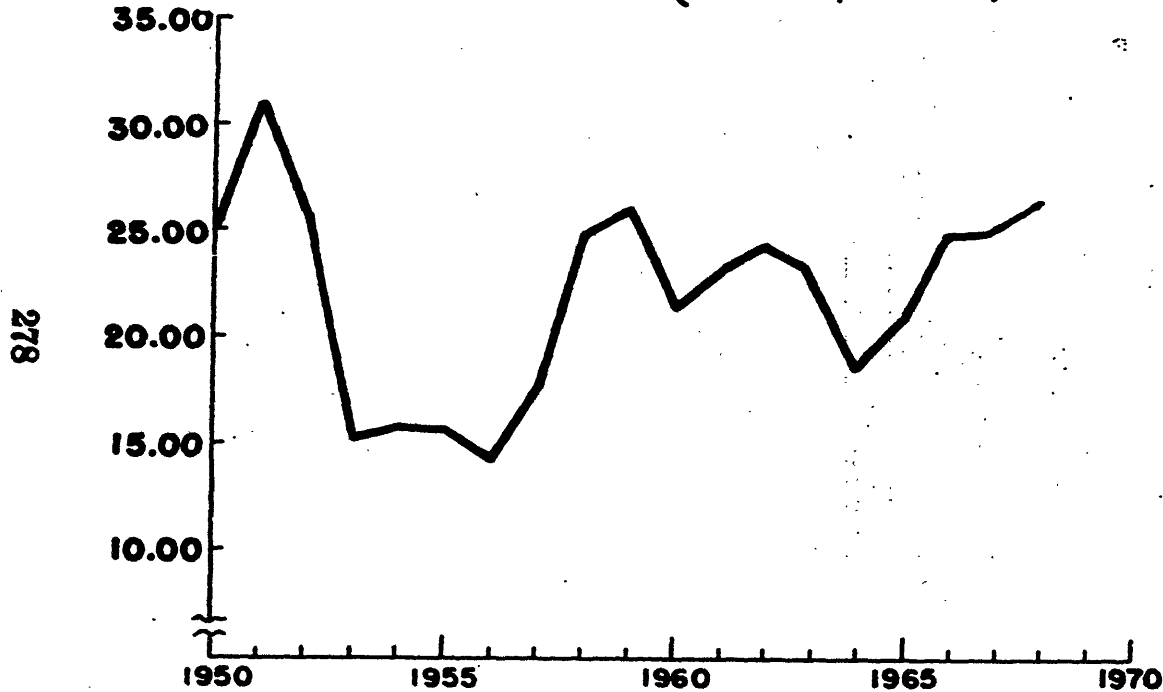


FIGURE 3



MONTHLY DATA

	1963	1964	1965
J	24.70	21.20	18.30
F	23.90	21.60	18.50
M	23.90	21.40	19.00
A	24.60	20.30	20.20
M	23.00	18.90	20.10
J	22.20	17.40	22.60
J	24.40	17.00	22.20
A	23.70	17.20	22.00
S	23.40	16.00	22.00
O	21.80	17.50	21.60
N	21.40	18.10	21.40
D	20.60	17.50	22.10

	1966	1967	1968
J	23.40	24.30	24.60
F	25.40	24.80	26.30
M	26.60	24.20	26.50
A	25.20	24.20	27.20
M	24.40	24.20	26.80
J	23.90	25.60	26.60
J	24.30	26.20	27.30
A	25.20	25.50	26.30
S	25.80	25.70	25.60
O	24.00	24.60	25.30
N	23.30	23.80	26.20
D	23.70	24.40	26.50

	1969	1970
J	27.20	
F	29.10	
M		
A		
M		
J		
J		
A		
S		
O		
N		
D		

FIGURE 4

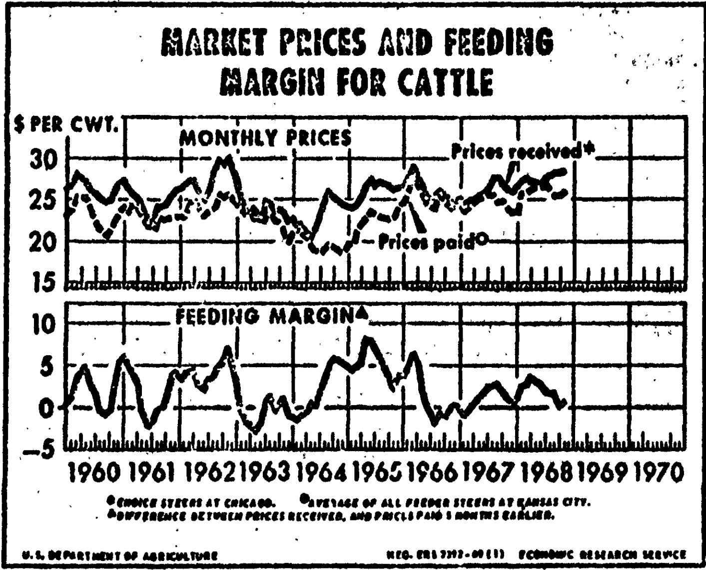


FIGURE 5

Table 1 - Off-farm Income Exceeds Farm Product Value

Tenure of operator	Percent of farm with other income exceeding value of farm products sold	
	1964	1959
Total commercial farm	16.7	12.5
Full owners	24.4	16.9
Part owners	10.5	10.1
Managers	4.5	12.6
All tenants	9.3	7.2
Cash	16.4	13.5
Share-cash	4.2	5.1
Crop-share	8.1	6.5
Livestock-share	4.6	5.6
Other	20.7	10.9

Table 2 - Proportion of farm-operator households having income from off-farm sources

Region	Percent of farms having income from off-the-farm sources exceeding value of farm products sold		
	1964	1959	1954*
United States	38.7	35.8	29.8
North	30.1	28.1	23.1
South	47.4	43.2	34.6
West	41.4	39.5	35.5

* Alaska and Hawaii not included

Table 3 - Farm operated households having off-farm income exceeding the value of farm products

Value of farm Products sold	Percent of farms with other income exceeding value of farm products sold			
	1964	1959*	1954*	1950*
Total	38.7	35.8	29.8	29.1
Under $2,500	76.0	62.5	46.6	43.0
$2,500 to $4,999	33.0	27.2	12.6	10.2
$5,000 to $9,999	9.8	12.6	6.4	8.3
$10,000 or more	1.1	6.5	4.5	4.3

* Alaska and Hawaii not included

SUMMARY OF
STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE SENATE COMMITTEE ON FINANCE
WITH REGARD TO TAX REFORMS (H.R. 13270)

Presented by

Marvin L. McLain, Legislative Director

September 22, 1969.

Farm Bureau has long included the broad subject of taxation and tax reform on its list of major concerns. At the time this legislation was under final consideration in the House, our organization made this concern clear publicly and expressed determination to seek changes in the bill when it is considered in the Senate.

Rising rates of taxation at nearly all levels of government and the progressive nature of the federal income tax have created both a tremendous pressure for so-called tax shelters and a critical reaction to such shelters. These factors are responsible for the current drive for various tax reforms.

The most pressing tax reform needed is a general reduction in federal taxation. For this to be possible, more effort will have to be made to bring spending under control. Likewise, it is also urgent that the tax laws be simplified.

H. R. 13270 would introduce many new complications into an already complex tax structure. For this reason, if for no other, we urge this Committee to act slowly and deliberately to make sure proposed tax reforms represent true reform and not new complications and frustrations for the average taxpayer. If necessary to allow time for adequate study, the features of H.R. 13270 which face time deadlines, such as the excise and surtax extensions, should be removed from the bill and given separate consideration.

Tax Treatment of Farm Losses

Farm Bureau has proposed that the tax loss problem be dealt with by placing a simple limitation of $15,000 on the amount of farm losses that can be used as an offset to non-farm income.

H. R. 13270 would (1) extend the holding period required for livestock to be eligible for capital gains treatment, and (2) repeal the livestock exemption from the depreciation recapture provisions of current law. Nowhere in the report of the house Ways and Means Committee or in the debate on the floor of the House is there any evidence of excessive "tax dodging" or other abuses resulting from these provisions of present law. We oppose both provisions.

Farm Bureau does not oppose the proposed creation of an Excess Deductions Account for taxpayers with farming losses provided the exemption from this requirement is not reduced below the $15,000-level. We have no objection to the proposed tightening of the so-called "hobby" loss provision of the current law.

Treatment of Cooperative Patronage Refunds

In 1962 we actively supported changes in the law which clearly defined

Treatment of Cooperative Patronage Refunds (Contd)

the tax status of cooperative allocations to member patrons. The provisions of H.R. 13270 would unnecessarily increase the federal government's role in the management of cooperative fiscal affairs. The 15-year pay-out requirement for retained patronage allocations would force cooperatives to treat these allocations as debt rather than equity, and thereby reduce their borrowing capacity.

Recognizing that cooperatives are owned and controlled by member-patrons, we believe such matters should be left to the decision of the members themselves.

Capital Gains

We are opposed to the proposed extension of the capital gains holding period to 12 months because it would discourage the investment that is needed to sustain economic growth. We are also opposed to the proposed elimination of the alternative tax rate on capital gains. While the alternative rate is normally of little concern to farmers, a great many farmers benefit from it when they sell a farm or liquidate their farming operations.

Tax Treatment of Tax-Exempt Bonds

We are opposed to the section of H.R. 13270 which deals with the tax treatment of income from presently tax-exempt state and municipal bonds. We view this proposed federal subsidy of such bonds as being nothing more than a "gimmick" which would result in still further involvement of the federal government in the fiscal affairs of state and local units of government.

We also ask the Committee to exempt income from state and municipal bonds from the provisions of H.R. 13270 which would establish a limit on tax preferences and require the allocation of deductions. If local governments are forced to pay higher interest rates to borrow money a part of the cost will fall on overburdened property owners including farmers.

Conclusion

Again, we urge that the Committee move forward cautiously in order to avoid actions that might disrupt important segments of our economy and to insure that the actions finally taken are based on sound premises rather than emotion.

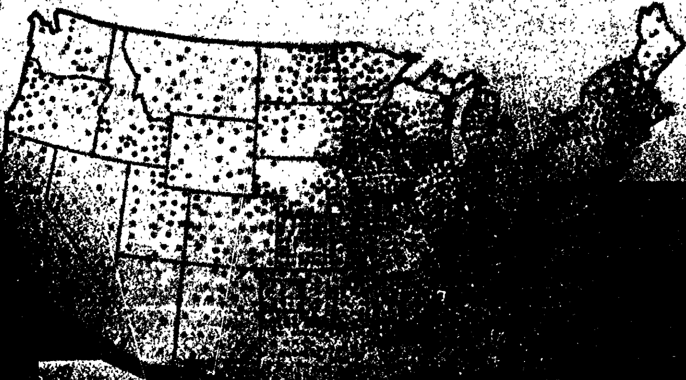
Farm Bureau is a voluntary, independent, non-governmental organization of farm and ranch families united for the purpose of analyzing their problems; initiating action to achieve educational improvement, economic opportunity, and social advancement and to promote the national welfare. Farm Bureau is local, statewide and national in its scope and is nonpartisan, nonsectarian, and non-secret in character.

TAX REFORM
H.R. 13270

Presented to
SENATE COMMITTEE ON FINANCE

By
Marvin L. McLain, Legislative Director

September 22, 1969



STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE SENATE COMMITTEE ON FINANCE
WITH REGARD TO TAX REFORMS (H.R. 13270)

Presented by

Marvin L. McLain, Legislative Director

September 22, 1969

Farm Bureau has long included the broad subject of taxation and tax reform on its list of major concerns. Earlier this year, when the House Ways and Means Committee conducted hearings on this entire subject, Farm Bureau presented testimony on several occasions.

Several aspects of the tax reform proposal now before you are of considerable concern to Farm Bureau members throughout the country. At the time this legislation was under final consideration in the House, our organization made this concern clear publicly and expressed determination to seek changes in the bill when it is considered in the Senate.

Most taxpayers view taxation as a means of raising the revenue necessary to carry out the essential functions of government. The growing use of taxation as a means of regulating the economy has resulted in a great deal of confusion and misunderstanding among taxpayers. At the same time sharply rising rates of taxation at nearly all levels of government and the progressive nature of the federal income tax have created both a tremendous pressure for so-called tax shelters and a critical reaction to such shelters. These factors are responsible for the current drive for various tax reforms.

In our view, and we believe it is a view held by most citizens, the most pressing tax reform needed is a general reduction in federal taxation. For this to be possible, more effort will have to be made to bring spending under control. This Committee, whatever its final conclusion may be, should

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make every effort to facilitate and encourage future general reductions both in the proportion of national income that is preempted by the federal government and in the progressivity of our tax system.

Likewise, it is also urgent that the tax laws be simplified. It is a poor tax system which results in overtaxation of millions simply because they do not understand tax laws and cannot afford to hire someone who does. The complexity of the tax laws is directly related to the high level of current taxes and the progressive nature of the rate structure. H.R. 13270 would introduce many new complications into an already complex tax structure. For this reason, if for no other, we urge this Committee to act slowly and deliberately to make sure proposed tax reforms represent true reform and not new complications and frustrations for the average taxpayer. If necessary to allow time for adequate study, the features of H.R. 13270 which face time deadlines, such as the excise and surtax extensions, should be removed from the bill and given separate consideration.

Underlying Farm Bureau's basic attitude towards taxation is a statement in the "Monetary, Spending, and Tax Policies" section of the Farm Bureau Policies for 1969 which reads in part as follows:

> " A stable domestic economy must be maintained in the interests of a high level of employment and a proper rate of economic growth as well as the protection of the value of the dollar.
>
> "Inflation is a serious threat to continued economic stability. To bring inflation under control and halt the decline in the value of the dollar, we must follow wise tax, budget, and monetary policies."

It is with this broad economic goal in mind that Farm Bureau sets forth its specific recommendations relative to H.R. 13270.

Tax Treatment of Farm Losses

Original suggestions for dealing with the matter of tax loss farming included elimination of both cash accounting for farmers and ranchers and capital gains treatment for livestock used for breeding. Since Farm Bureau members believe the elimination of these features of present tax law would be extremely harmful to a large segment of agriculture, Farm Bureau proposed that the tax loss problem be dealt with by placing a simple limitation of $15,000 on the amount of farm losses that can be used as an offset to non-farm income. This approach was introduced by several members of the House.

Subsequently, the House included in H.R. 13270 two provisions which, while alleged to be methods of dealing with the abuse of farming losses by taxpayers with non-farm income, actually would work to the detriment of thousands of full-time farmers. We refer specifically to the provisions which would (1) extend the holding period required for livestock to be eligible for capital gains treatment, and (2) repeal the livestock exemption from the depreciation recapture provisions of current law. Nowhere in the report of the House Ways and Means Committee or in the debate on the floor of the House is there any evidence of excessive "tax dodging" or other abuses resulting from these provisions of present law.

While the proposed extension of the holding period for capital gains might not work a serious hardship on the producers of cattle and horses, it would work an extreme hardship on farmers engaged in the breeding and production of livestock with a shorter life span (namely, hogs and fur-bearing animals).

It also should be noted that the bill as drafted by the House does not specifically state whether the one-year holding period would begin at the beginning or end of normal gestation. This in iteself has caused some confusion. If the holding period is to begin at the end of gestation, capital gains treatment would largely be eliminated for most of the smaller species of livestock. For example, most hog breeders maintain female stock for only one or two farrowings.

The proposed extension of the depreciation recapture provisions of the current law to livestock fails to recognize that livestock is different from other personal property, i.e., that maintenance of livestock is a fairly high risk business for which adequate insurance is not available. Even though some may view this matter differently, farmers faced with a disastrous cost-price squeeze during the current inflationary period view this change as one which would only increase their costs without contributing a great deal to the economy as a whole or the goal of tax reform.

Farm Bureau does not oppose the proposed creation of an Excess Deductions Account for taxpayers with farming losses provided the exemption from this requirement is not reduced below the $15,000-level which has been suggested by the Treasury Department and which is the level previously proposed by Farm Bureau as a ceiling on the deduction of farm losses from non-farm income. We have no objection to the proposed tightening of the so-called "hobby" loss provision of the current law.

Treatment of Cooperative Patronage Refunds

This matter was not included in the House hearings on tax reform. Therefore, when these changes were proposed in the Ways and Means Committee, Farm Bureau asked that action be delayed until interested parties could be heard. Now that this Committee is giving the matter a hearing, our position is as follows:

Over the years Farm Bureau has taken an active part in improving and strengthening farmer cooperatives. In 1962 we actively supported changes in the law which clearly defined the tax status of cooperative allocations to member patrons.

We believe changes made at that time were sound and that current law with respect to cooperative activities is adequate.

The provisions of H.R. 13270 would unnecessarily increase the federal government's role in the management of cooperative fiscal affairs. The purpose clearly is to restrict cooperative activities rather than to improve the equity of the tax system.

Among other things, the provisions of H.R. 13270 seek to force cooperatives to adopt a 15-year pay-out requirement for retained patronage allocations. This, in effect, would force cooperatives to treat these allocations as debt rather than equity, and thereby reduce their borrowing capacity. A mandatory pay-out requirement for all patronage allocations also would make it difficult for cooperatives to give priority to the redemption of allocations held by retiring members and the estates of deceased members. Recognizing that cooperatives are owned and controlled by member-patrons, we believe

patronage allocations also would make it difficult for cooperatives to give priority to the redemption of allocations held by retiring members and the estates of decreased members. Recognizing that cooperatives are owned and controlled by member-patrons, we believe such matters should be left to the decision of the members themselves.

Capital Gains

We have already addressed ourselves to the matter of capital gains treatment of livestock. Official Farm Bureau policy includes a statement on the general subject of "capital gains" as follows:

> "The tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property.
>
> "The present law results in the taxation of 'gains' which reflect in part a decline in the value of the dollar. In periods of rising prices this penalizes property owners and discourages the sale of property.
>
> "As a partial answer to this inequity we recommend that the rate of tax on capital gains be reduced as the length of the holding period increases. We favor retention of the present minimum holding period.
>
> "Where farmland is acquired for public use by eminent domain or private treaty, the owner should be permitted a period longer than one year to reinvest in farming or another business with the same tax treatment. We support the present law with respect to capital gains treatment for sales of breeding livestock."

We are opposed to the proposed extension of the capital gains holding period to 12 months because it would discourage the investment that is needed to sustain economic growth. The fact that capital gains can be taken at the end of 6 months makes investors more willing to supply risk capital to new ventures, even though they may have no intention of turning over their investments at such a rapid rate.

We are also opposed to the proposed elimination of the alternative tax rate on capital gains. While the alternative rate is normally of little concern to farmers, a great many farmers benefit from it when they sell a farm or liquidate their farming operations. The capital gains realized by farmers in the sale of a farm or a herd of livestock often represent a lifetime of work which ends up being taxed all at once. In such instances we believe the alternative rate is not only beneficial, but fair to both the taxpayers and the government. This is particularly true in times such as the present when much of what the law defines as "capital gains" is the result of inflation. Excessive taxation of inflation-created gains represents destruction of capital and should be avoided.

Tax Treatment of Tax-Exempt Bonds

We are opposed to the section of H.R. 13270 which deals with the tax treatment of income from presently tax-exempt state and municipal bonds. We view this proposed federal subsidy of such bonds as being nothing more than a "gimmick" which would result in still further involvement of the federal government in the fiscal affairs of state and local units of government.

We also ask the Committee to exempt income from state and municipal bonds from the provisions of H.R. 13270 which would establish a limit on tax preferences and require the allocation of deductions. These provisions are clearly a back-handed effort to impair the tax-exempt status of state and municipal bonds. We believe that these bonds should remain tax exempt, and that their status should not be impaired by indirection. If local governments are forced to pay higher interest rates to borrow money a part of the cost will fall on overburdened property owners including farmers.

The uncertainty created by House actions affecting tax-exempt bonds has made it difficult for state and local governments to sell new bonds. We urge the Committee to take prompt action to remove the cloud on the future treatment of the income from such bonds.

Conclusion

Many have argued that tax reform has been too long in the making and that we must have action now. But, with our own economy and that of the entire Western World in a rather delicate balance, hasty action could prove disastrous. Again, we urge that the Committee move forward cautiously in order to avoid actions that might disrupt important segments of our economy and to insure that the actions finally taken are based on sound premises rather than emotion.

We thank you for this opportunity to express our views.

Statement of

Harry L. Graham

Legislative Representative

National Farmers Organization

Senate Finance Committee

September 22, 1969

The National Farmers Organization is an association of farmers which is engaged in collective bargaining in an effort to improve farm income.

We accomplish our marketing objectives by blocking together enough production in any commodity to enable us to have some influence on the market.

The policy of the organization is to support the family-size owner-operator farms both because they represent the greatest economic efficiency and the maximum social and political stability which is essential for the welfare of our nation.

We therefore support legislation which will accomplish our economic, social and political goals, and we oppose those acts which contribute to the weakening of our desirable and essential objectives.

With this background, this distinguished committee will not be suprised that the N. F. O. opposes any tax

law or its implementation which will give an economic advantage to the farms and their owners who do not depend upon the farming operation for their profits and especially those which enable those who have large losses in their farming operations to deduct these losses from their other economic losses from thier other economic operations.

The use of short-term capital gains as a means of creating a paper loss or to avoid taxes which would be colleited if this income was treated as corporation income is particularly objectionable to us as it should be to the Congress.

The preferential tax treatment extended to farmers by the Congress was a justified attempt to help alleviate the lock of economic equality with the rest of the economy which has been the lot of farmers except during wartime for over fifty years.

It seems to the N.F.O. that the Congress should do two things;first, it should limit the farms losses which may be charged off against non-farm income; second, it should tighten up the privileges being extended to reduce taxes by the application of capital gains to relatively short term investments.

If an animal is simply fed out for the market, there probably is no justification for treating the profit from this operation as capital gains. If an animal is held to maturity and used for breeding purposes, the profits which

which accrue to the operation should be treated as capital gains.

There is an problem in this area which troubles us. The two year minimum is certainly justified in the case of cattle. Maybe it could even be increased. However, in the case of swine, the time which it takes for the animal to mature, be bred, and repsoduce is less than two years. Good gilts can be bred at about four months and prodúce a litter in nine or ten months. Thus, in about a year, the gilt has become a sow and is at the maximum size to sell without taking a substantial loss due to a size for which there is not much demand.

We would therefore recommend that the minimum time requirements to make swine eligible for capital gains be reduced to one year.

We also would like to make reccommendations on two other matters which are before this committee.

First, we urge that the investment tax credit be continued for agriculture until such time when the income for the factors of production - risk, labor, investment and management reaches a reasonable equality with the return of these factors when they are committed to the other segments of our economy.

Second, we would point out that the N.F.O. is not

effected by tax laws as they apply to cooperatives. However, we believe that cooperatives usually use their earnings in a way which contributes to the welfare of their membership. We therefore believe that the tax proposals in Sec. 531 are such as to cause hardship and damage to the cooperatives and we urge that this section be eliminated and the present law, which was only recently enacted by the Congress, be retained.

We commend the committee for its efforts to improve the tax laws. We have great confidence in the ability, integrity and wisdom of this Committee. We hope that you will agree with the positions which we commend to you as also being reasonable and fair.

Statement and Summary of
Angus McDonald, Director of Research
National Farmers Union

PERTAINING TO THE PROVISIONS IN THE TAX REFORM ACT OF 1969 WHICH RELATE TO FARM COOPERATIVES, AND IN SUPPORT OF S. 500 WHICH WOULD LIMIT THE AMOUNT OF DEDUCTIONS UNDER OUR TAX LAWS ATTRIBUTABLE TO FARMING USED TO OFFSET NON-FARM INCOME

Presented to the
Senate Finance Committee
September 22, 1969

NATIONAL FARMERS UNION • SUITE 1200 - 1012 14th STREET, N.W., WASHINGTON, D.C. 20005 • PHONE 628-9774

SUMMARY STATEMENT

1. National Farmers Union is unequivocably opposed to the punitive, non-revenue producing cooperative provisions of the Tax Reform Act of 1969. These provisions were inserted in the bill without warning and with no opportunity for affected groups to present their views.

2. The National Farmers Union supports S. 500, sponsored by Senator Metcalf and 22 other Senators. This legislation would stop one gigantic loophole in our tax laws which permits wealthy individuals to avoid payment of their fair share of taxes. The so-called "tax farmers" engage in activities adverse to working farmers. They inflate the price of land and enter into competition with farmers who have no off-farm income.

3. The enactment of the cooperative provisions of the tax bill would reverse and repudiate the 50-year policy of Congress in regard to cooperatives. They would work such a hardship on cooperatives that many would be forced out of existence.

4. The cooperative provision which would ultimately require 50 percent of the patronage refund to be paid in cash is an unwarranted intrusion into a business. It would penalize cooperatives regardless of the wishes of a majority of their members and would entail additional bookkeeping.

5. The provision requiring all redemption of paper within 15 years would affect adversely the capital needs and credit of cooperatives.

6. The suggestions made in regard to farm-loss abuses are unsatisfactory and cannot be accepted by the Farmers Union. The Excess Deductions Account provision in the House bill would affect very few tax dodgers and bring in little additional revenue.

7. The Metcalf bill would, on the contrary, bring in additional revenue and would effectively close the loophole during the year when tax-dodging was resorted to. It would not foreclose taxpayers using the accrual method which is required of other businesses. It would, contrary to the House and Administration recommendations, protect the farmer in regard to losses incurred because of drouth, flood and in regard to certain other deductions.

Statement of
Angus McDonald, Director of Research
National Farmers Union
PERTAINING TO THE PROVISIONS IN THE TAX REFORM ACT OF 1969 WHICH RELATE TO FARM COOPERATIVES, AND IN SUPPORT OF S. 500 WHICH WOULD LIMIT THE AMOUNT OF DEDUCTIONS UNDER OUR TAX LAWS ATTRIBUTABLE TO FARMING USED TO OFFSET NON-FARM INCOME
Presented to the
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September 22, 1969

Mr. Chairman and Members of the Committee:

I will comment briefly on two subjects before this Committee. One relates to farm cooperative provisions in the tax reform bill and the other to S. 500, introduced by Senator Lee Metcalf and sponsored by twenty other Senators. Our comments on all legislation reflect our concern over the decline of farm income due to inflation, to lack of bargaining power, to discrimination against cooperatives and against farmers.

Historically the farmer has always been a second class citizen. His income has consistently been much lower than those of persons in other industries. Senator Proxmire characterized this situation some years ago as being the shame of America. The farmer has not shared in our so-called "affluent society." President Harry S. Truman, it was reported, had a sign on his desk as follows: "The buck stops here." The American farmer should post such a sign on his mailbox. He has no one to pass his costs on to. He has little to say about what he is paid in the marketplace. He is caught in an economic vise.

In the marketplace he faces oligopoly. How can he dictate the price of his eggs or his cattle or his grain when he faces a group of corporations who tacitly or otherwise have agreed on the price they will pay him. How can he bargain over the price of a truck or a tractor when the price is administered by a small, tight group of manufacturers who control 50 to 90 percent of production?

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The farmer may resort to two courses of action--he may petition Congress to enact laws which introduce some kind of rationale into the marketing of his commodities. He may ask that certain devices be instituted which will shore up prices which often fall below cost of production. The other action available to the farmer is to pool his bargaining power by means of cooperatives. The history of the farmer's effort to build a countervailing power to offset the gigantic power of corporations is long and tortuous. He has been persecuted; he has been discriminated against, and he has even been charged with criminal activities when he and his neighbors pooled their economic resources.

Congress has recognized the farmer's right to organize cooperatives. Beginning with the year 1898 Congress has passed laws which attempted to clarify and support the farmer's inalienable right to join with his neighbor in his economic activities. These laws attempted to clarify the farmer's constitutional right to bargain, but they also attempted to clarify the relationship of cooperatives to the antitrust laws. Here is a partial list of laws which set forth the policy of the Congress. They repeatedly stated that cooperatives were good, were legal, and should be encouraged, fostered and preserved by our Government:

(1) War Revenue Act of 1898 (30 Stat. 448, 461)

(2) Corporation Tax Statute of 1909 (36 Stat. 11, 113)

(3) War Finance Corporation Act of 1918 (42 Stat. 181, 182)

(4) Federal Reserve Act Amendment 1923 (42 Stat. 1479, 1480, 12 U.S.C.A. 351)

(5) Federal Intermediate Credit Banks Act of 1923 (42 Stat. 1454, 12 U.S.C.A. 1021)

(6) Agricultural Marketing Act of 1929 (46 Stat. 11, 12 U.S.C.A. 1141)

(7) Farm Credit Act of 1933 (48 Stat. 257, 261, 12 U.S.C.A. 1134, 1134f)

Here is what Congress said in the Agricultural Commodity Act of 1929:

"It is hereby declared to be the policy of Congress to promote the effective merchandising of agricultural commodities.....

"(3) By encouraging the organization of producers into effective associations or corporations under their own control for greater unity of effort in marketing and by promoting the establishment and financing of a farm marketing system of producer-owned and producer-controlled cooperative associations and other agencies."

Congress not only stated very clearly its policy in regard to cooperatives, but set up institutions for the specific purpose of assisting cooperatives. In the Federal Farm Board Act and in the Farm Credit Act of 1933, it set up organizations for the specific purpose of helping cooperatives. Among these were the 12 regional banks for cooperatives and the Central Bank for Cooperatives. Mindful of the fact that abuses might arise, the Farm Credit Act set forth certain rigid rules in regard to cooperatives as follows:

"As used in this act, the term 'cooperative association' means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services: PROVIDED, HOWEVER, That such associations are operated for the mutual benefit of the members thereof as such producers or purchasers and conform to one or both of the following requirements:

"First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

"Second. That the association does not pay dividends on stock or membership capital in excess of 8 percentum per annum.

"And in any case to the following:

"Third. That the association shall not deal in farm

products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association."

In order that the often meager savings which resulted from buying and selling in large quantities might not be subject to corporation taxes, certain rules were set up by the Congress and by the Treasury. In 1962 the tax law relating to cooperatives was changed to require that 20 percent of patronage refunds be paid in cash and that the consent of the member in regard to investment of patronage refunds in the cooperative be authorized in writing by the individual member or by a provision in the by-laws which must be agreed to by a majority of the members. Farmers Union opposed this provision, believing that it was an unwarranted interference in the private affairs of the business.

It should be made clear that all patronage refunds under our tax laws, in whatever form, must be reported to the Treasury as income. The only excuse for requiring a patronage refund to be paid in cash is that the cooperative unlawfully withholds payment from the member or that the member does not report his patronage refund to the Treasury when it is not paid in cash. We strongly believe that the American farmer is as honest, even more honest, than other taxpayers and that the inference that he is dishonest is unwarranted.

Now, like a bolt out of the blue comes the recommendation of the House of Representatives. No opportunity was given for cooperatives and other interested groups to present their views in regard to the punitive, non-revenue producing provisions inserted almost at the last minute in the House Tax Reform Act of 1969. Protests to the Committee and to the House of Representatives were unavailing.

Yet, we do not think that the importance of these damaging recommendations can be exaggerated. One requirement says that three percent a year beginning with 1970 is to be added until 50 percent of the refund is paid in cash to the patron. This provision ignores the fact that a majority of the members may have indicated that they wanted all of their patronage refunds, or at

least a larger part, reinvested in the business. One can imagine the bookkeeping entailed in obtaining funds represented by checks from individual members for reinvestment in the cooperative. Red tape and inefficiency would inevitably result from such procedure.

The other provision which says that investment in the cooperatives must be repaid in cash within 15 years is even more damaging. It changes on the books of the cooperative an asset to a liability. It would make difficult, we are told by experts, the obtaining of loans from banks. It would involve the raising of cash from time to time which might not be available, particularly when large investments have been made in necessary equipment. In these days of rapidly developing technology a large capital investment is absolutely necessary if a business is to grow and compete.

If the Congress enacts this provision it is saying, in effect, "We repudiate all past policies in regard to cooperatives. We disagree with many laws on the books which encourage and assist voluntary cooperation among farmers. We are, in effect, opposed to the Farm Credit Administration and the Rural Electrification Administration, which are agencies established to fulfill that governmental policy."

These provisions in the House bill strike at the backbone of hundreds of rural communities and forestall the possibility of organizing new cooperatives to furnish farm supplies and market and process farm products.

During the last few years there has been a great deal of publicity in regard to the gigantic loopholes in our tax laws. One of the most notorious is that loophole which allows wealthy individuals to invest in farming activities for the purpose of tax avoidance. The Farmers Union has been studying various proposals which have been made in regard to this loophole which affects directly and adversely the welfare of farmers. Our attention was called to certain statistics published by the Treasury Department which indicate that wealthy individuals were purposely losing money in the farming business. These tables, attached hereto as Exhibits A and B, substantiate this belief.

Attached also as Exhibit C, is a table published in the Congressional Record of October 4, 1968, which proves that an economic net income of $10,000 can be converted into a $10,000 net loss for tax purposes.

The Treasury Department has published much statistical information to illustrate this point. One example is given: Assuming that the expenses of raising a herd of cattle are $200,000, it is obvious that the taxpayer in the top tax bracket will incur a tax saving of $140,000. On the sale of the herd, however, the entire sales price, including the $200,000 representing the recovery of these expenses, will be taxable only at the 25 percent capital gains rate. The capital gains tax on $200,000 is $50,000, or less than half the tax savings realized in the earlier years. Thus, the taxpayer in this situation would realize a $90,000 tax profit from a transaction which economically is merely a break-even.

S. 500 would go far in eliminating abuses engaged in by wealthy individuals and corporations. It would limit the losses of a farm entrepreneur to $15,000 plus taxes, interest and losses resulting from natural disasters. It would not, as its opponents say, require that all farmers resort to the accrual method. Under this legislation taxpayers would still have the option of selecting the method they prefer. However, if they did not restrict themselves to the restrictions under the $15,000 rule they would be required to report their inventory as do other businesses.

The suggested alternatives in regard to farm losses are not acceptable to my organization. The Excess Loss Deductions Account would allow the taxpayer to deduct his losses during the current tax year, no matter how huge. As we understand the House-passed measure, only those losses above $25,000 would be set aside in the deduction account. Furthermore, only those individuals whose outside income was in excess of $50,000 a year would be required to set up the account. Thus, all other taxpayers would escape even the Excess Deduction Account method which postpones the time when the taxpayer would be required to report capital gains as regular income up to the amount of the Excess Deductions Account.

The recommendations of the Administration in regard to the EDA treatment are somewhat of an improvement over the House version. Recently Secretary Kennedy recommended that the EDA rules apply to any taxpayer with non-farm adjusted gross income in excess of $25,000 losses which exceeded $15,000. Originally the Treasury's suggestion was that this latest figure be $5,000. It appears that the alternative to S. 500 in some respects has gone from bad to worse.

Another provision in the House bill is also objectionable. It requires that capital gains treatment can only apply to livestock after it has been held one year after reaching breeding age. This provision would no doubt work a hardship on many small operators.

It should be emphasized that the Metcalf bill takes into account certain hazards which are unique to farming operations. It would not, for tax purposes, include in the $15,000 ceiling deductions attributable to taxes, interest, the abandonment or theft of farm property, losses of farm property arising from fire, storm or other casualties, losses or expenses attributable to drought, and losses from sales, exchanges and involuntary conversions of farm property.

EXHIBIT "A"

The following statistics lead us to believe that wealthy individuals have been using farm investments to escape payment of taxes:

ALL 1965 INCOME TAX RETURNS OF INDIVIDUALS RELATING TO FARMING BY ADJUSTED GROSS INCOME CLASSES

	Net Profit		Net Loss	
	Number of Returns	Amount (Thousand Dollars)	Number of Returns	Amount (Thousand Dollars)
Taxable Returns, Total:	1,151,882	$3,951,260	661,860	$1,001,106
Under $1,000..........	6,546	$ 4,338	-	$ -
$1,000 under $2,000...	65,519	69,113	16,603	13,739
$2,000 under $3,000...	107,019	168,442	35,891	32,770
$3,000 under $4,000...	139,737	259,685	64,020	63,354
$4,000 under $5,000...	140,030	314,961	80,522	92,672
$5,000 under $6,000...	132,512	345,937	83,450	84,166
$6,000 under $7,000...	114,602	334,594	80,887	85,396
$7,000 under $8,000...	96,434	293,086	68,302	64,550
$8,000 under $9,000...	72,525	267,080	47,547	50,125
$9,000 under $10,000..	57,875	242,904	39,555	50,706
$10,000 under $15,000..	132,109	724,204	79,564	123,177
$15,000 under $20,000..	42,160	347,490	23,843	60,292
$20,000 under $50,000..	38,752	471,138	30,380	133,187
$50,000 under 100,000..	4,974	82,700	7,424	76,852
$100,000 under 500,000..	1,040	23,464	2,874	54,872
$500,000 under 1,000,000	32	518	170	6,625
$1,000,000 or more	16	1,606	103	7,630

SOURCE: Statistics of Income, 1965, Individual Income Tax Returns, U. S. Treasury Department, Internal Revenue Service.

ACTIVE CORPORATION INCOME TAX RETURNS
July 1965 - June 1966

No. of Returns with and without net income...............	18,526
With Net Income......................................	10,387
Without Net Income...................................	8,139
Form 1120-S..	4,862
Without Net Income (Form 1120-S).....................	2,330

SOURCE: Book of Statistics of Income, U. S. Treasury Department, Internal Revenue Service

EXHIBIT "B"

ALL 1966 INCOME TAX RETURNS RELATING TO FARMING
BY ADJUSTED GROSS INCOME CLASSES

	Net Profit		Net Loss	
	Number of Returns	Amount (Thousand Dollars)	Number of Returns	Amount (Thousand Dollars)
Taxable returns, total:	1,280,274	$4,816,041	674,220	$1,023,640
Under $1,000..........	7,357	$ 5,368	-	-
$1,000 under $2,000...	62,996	63,922	13,846	8,800
$2,000 under $3,000...	101,077	156,069	32,625	36,417
$3,000 under $4,000...	142,674	265,644	54,468	46,642
$4,000 under $5,000...	140,953	324,578	69,685	74,080
$5,000 under $6,000...	128,965	340,690	78,951	73,197
$6,000 under $7,000...	124,300	362,437	76,057	81,706
$7,000 under $8,000...	110,725	358,421	70,246	78,998
$8,000 under $9,000...	88,926	338,673	57,179	65,461
$9,000 under 10,000...	78,989	353,168	42,090	50,269
$10,000 under 15,000...	180,645	1,007,111	100,209	137,525
$15,000 under 20,000...	56,150	495,227	30,520	73,530
$20,000 under 50,000...	49,658	626,647	35,621	150,365
$50,000 under 100,000..	5,622	92,412	8,580	73,457
$100,000 under 200,000..	986	19,833	2,357	36,663
$200,000 under 500,000..	209	5,049	895	24,507
$500,000 under 1,000,000..	27	620	201	7,816
$1,000,000 or more........	15	172	88	3,563

SOURCE: Book of Statistics of Income, U. S. Treasury, Department of Internal Revenue Service

EXHIBIT "C"

TAX ADVANTAGES OF CATTLE OPERATIONS*

Economic Situation:

Gain from sale of breeding cows classified as section 1231 property.................	$ 40,000
Ordinary income from sale of feed and gain from sale of calves and steers..........	70,000
Gross Profit..........................	$ 110,000
Less: ordinary expenses including depreciation...........................	100,000
Economic Net Income	$ 10,000

Tax Situation:

Ordinary income from sale of feed and gain from sale of calves and steers..........	$ 70,000
Loss: Ordinary expenses including depreciation...........................	100,000
Ordinary loss.........................	(30,000)
Section 1231 gain......................	40,000
Less: Long-term capital gain deduction...	20,000
Taxable portion of capital gain.........	20,000
Net Loss for Tax Purposes................	(10,000)

*Source: Prentice-Hall, Inc., "Tax Ideas" - July 3, 1968

STATEMENT BY ROBERT M. FREDERICK, LEGISLATIVE REPRESENTATIVE OF THE NATIONAL GRANGE, BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE, September 22, 1969
Re: H.R. 13270, "Tax Reform Act of 1969"

SUMMARY SHEET

I. Tax-loss Farming

H.R. 13270 undertakes to correct a situation in which some high-income taxpayers, not primarily engaged in farming, have used farm losses to obtain a deduction in their high-bracket non-farm income.

To do this, H.R. 13270 requires the taxpayer to maintain an excess deductions account to record his farm losses. In the case of individual farm losses would be added to the excess deductions account only if the taxpayer had income from nonfarm sources of more than $50,000 for the year, and only to the extent that the farm loss for the year exceeded $25,000.

In our judgment, the E.D.A. account approach does not strike at the heart of the "tax-loss" farming loophole. It only postpones the issue and strikes at all farmers, big and small, bona fide as well as the investor who is investing in agriculture for a profit. In doing so, it includes the "tax-loss" tax-dodging farmer. In referring to the latter, we use the word "farmer" rather loosely.

It is our firm belief that the provisions of the Amendment No. 139 introduced by Senator Metcalf on August 13, 1969 will correct the abuse of the liberal tax rules provided in the Internal Revenue Code for the use of bona fide farmers. Therefore, we respectfully urge that Amendment No. 139 be inserted in H.R. 13270 in place of part of Subtitle B-Farm Loss, etc., starting at line 10, page 139 of the bill and striking all that follows through line 6 on page 152.

In our judgment, this method will be more in line with true tax reforms in providing more revenue for the Federal Treasury, a

shifting of the tax burden and expediting the closing of tax loopholes that allow revenue losses.

It is our understanding that the E.D.A. and other farm tax proposals of the House bill will only apply to an additional 3000 persons and bring into the Federal Treasury an additional $25 million by the year 1979, such increase to come from correction in the tax-loss farming, depreciation recapture, holding period for livestock and a negligible amount from hobby-farm losses.

The amendment proposed by Senator Metcalf, Amendment No. 139 would apply to 14,000 taxpayers, thereby shifting the tax burden, and would bring in an additional $205 million per year as soon as the bill became effective. In our opinion, this is true tax reform, because it increases Federal revenue at the same time it shifts the tax burden and the effect is immediate, and as we pointed out earlier in our testimony, it hits at the "jugular vein" of the tax-dodge farming.

This corrective amendment will affect only non-farmers with large amounts of nonfarm income who invest in farming to obtain tax losses.

Senator Metcalf has explained that he considered the E.D.A. approach when he first began to look into ways to correct the tax-dodging farm problem. In remarks before the Senate August 13, he said:

"After a great deal of technical discussion with experts, I was convinced that the most effective way to get at this problem without hurting the legitimate farmer would be to take the loss limitation approach. Under this method, a dollar limit would be placed on the amount of artificially created farm losses that could be used as an offset against nonfarm income in any given year."

The family farm structure in American agriculture must be given an even break with others engaged in agriculture for profit. It is our opinion that Amendment No. 139 will give us equality of income tax treatment and preserve for agriculture the liberal provisions of the Internal Revenue Code that were meant for farmers who farm for a livelihood.

It is the opinion of the National Grange that the provisions of Amendment No. 139 meet the needs of the American farmer far better than the first part of Subtitle B of H.R. 13270, thereby making any further changes in the Internal Revenue Code pertaining to agriculture unnecessary.

This corrective amendment will affect only non-farmers with large amounts of non-farm income who invest in farming in order to obtain tax losses which may be set off against their non-farm income.

II. Hobby Losses

We believe that if the Metcalf amendment is adopted by this Committee there will be no need to make further provisions in the law for the so-called "hobby farmers".

As stated by Senator Metcalf before the Senate on August 13, 1969 when he introduced his amendment, "...The loss limitation approach would include the hobby loss farmer and would limit the current deduction of his farm losses."

There exists the mistaken impression that H.R. 13270 would discourage hobby farming to a greater extent than the amendment introduced by Senator Metcalf. In the opinion of the author and the Grange, this is not the case.

III. Holding Period for Livestock

In H.R. 13270, livestock for dairy, draft or breeding purposes are discriminated against in only this one major provision. It requires that such animals be held for at least 365 days after such animals would have first been used for such purpose. There is no similar provision for other personal property, such as machinery. Basically the requirement is that the item not be held for customers in the ordinary course of business.

We do not believe that the tax rules should be made more stringent against the farm industry at a time when it is undergoing severe economic problems. We therefore believe that the same rules regarding holding period for capital gains should apply to livestock.

This can be accomplished by striking the following in lines 7 and 8 on page 153, "for at least 365 days". Lines 7 and 8, page 153, would then read "but only if held by him after such animal normally would have first been used for any of such purposes."

We realize that one of the problems of our proposal would be one of intent. However, we believe our proposal fully meets the necessary requirements in this respect. In essence, under our proposal, until an animal became a draft, dairy or breeding animal, it would not qualify for long-term capital gains treatment. Once it had reached such status (draft, dairy or breeding) it would clearly show that this was the intent of its owner and that he was not primarily holding it for sale to customers in the ordinary course of business.

IV. Cooperative Tax Revisions

The National Grange was shocked to learn of the proposed changes in co-op tax treatment contained in H.R. 13270 as passed by the U.S. House of Representatives and now pending in the tax reform legislation before this Committee. Quite frankly, we do not see that

co-op tax treatment has any connection whatsoever to "tax reform", the announced reason for holding these very hearings.

In our opinion "tax reform" should meet the following tests: (1) increase revenue to the Federal Treasury; (2) expedite the collection of the tax; and (3) shift the tax burden to those who are not carrying their share of the tax burden from those who are presently paying more than their proportionate share. The cooperative tax treatment in H.R. 13270 meets none of these tests.

We followed each press release of the House Ways and Means Committee regarding tax measures to be heard by the Committee and not once did we find the subject of co-op tax treatment listed as a subject for discussion. Therefore, neither we nor any other farm organization was permitted the privilege of open debate on such an important matter to agriculture as the tax treatment of farm co-ops, that was accorded the anti-co-op lobbyists who were permitted to have the subject introduced during the closing days of the executive hearings of the House Ways and Means Committee.

Our last ditch efforts in the Ways and Means Committee were successful only in extending the time in which small co-ops will be permitted to live and serve agriculture and rural America. Such hasty action on a subject of vital concern to the lifeblood of all small co-ops can have a devastating effect and completely wipe out many such co-op marketing organizations. In attacking the "giants", the "Davids" will also be slain, quite contrary to the Biblical story.

We would all agree it is desirable that the farmer receive as big a cash refund as possible, as quickly as it can be paid. This already is being done. Farmers, through an elected board of directors, decide each year what amounts they can take in cash and what amounts they must defer in order to provide capital for the cooperative.

But the proposed new regulations would take that decision away from the farmer and instead write a 15-year limit into law. This would put a "due date" on the farmer's investment in the co-ops and change the nature of that investment from "equity" to "debt capital". This could completely disrupt the capital structure of the cooperative and impair its ability to borrow money.

The 15-year payout provision is one of the least-understood yet potentially the most damaging of the new rules being proposed for cooperatives.

Secretary of Agriculture, Clifford Hardin, in addressing the annual meeting of the American Institute of Cooperation, in Urbana, Illinois on August 4, 1969, stated:

> "Cooperatives are a positive and dynamic force in rural development. They have proved themselves an effective instrument in helping farm families make more effective use of their agricultural resources. Many cooperatives are also providing the original impetus for new community enterprises. In some communities the cooperative is the area's biggest industry.
>
> "But cooperatives can, and must, do more, not only to increase job opportunities and income, but to be a positive force in helping local communities initiate and carry out new development projects."

We suggest to this Committee that cooperatives cannot aid farmers or rural America if they are "bled" to death by such measures as contained in Sec. 531 of H.R. 13270.

Official figures buttress our case. They show, for example --

. That the income of farm families is about 75 percent as much as that of nonfarm families.

. That prices paid by farmers increased 28 percent from 1957-59 to mid-1969, compared with a 17 percent rise in the overall

consumer price index and a 24 percent increase in retail food prices.

. That food prices have risen only two-thirds as much as those of all other consumer goods in the past 10 years.

. Agricultural output per man-hour increased 82 percent between 1957-59 and 1968.

. One farm worker in 1967 supplied the needs of 43 people compared with 23 in 1957-59.

. Farmers in recent years have increased their productivity b 5.3 percent, a rate twice that of industry.

To date we, as producers of this abundance of food and fiber, have not shared in the benefits of our labors. Farm cooperatives are one way and perhaps the best way that farmers can increase their economic position in relationship to other segments of our society -- and now this avenue of economic improvement is being throatened by so-called "Co-op Tax reforms". The destruction of cooperatives appears to be the only purpose of the measure as it would deny cooperatives the same right to use their earnings for legitimate business purposes that corporations have had from the beginning of corporate history.

It's too bad that we must once again be asking busy Senators to devote time to a matter which seemingly was settled in 1962 after lengthy hearings and debate. Here you are confronted with what has been called the most sweeping tax reform measure in history. And among the many sections is a measure which has nothing to do with tax reform; which would not yield any additional tax revenue nor any additional tax benefit; but which could greatly restrict the growth of farmer cooperatives.

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We see no justification for new laws governing cooperative financing or taxation. We will urge -- in the strongest possible appeal -- that the entire section on cooperatives be deleted from the Tax Reform Act of 1969.

V. Federal Estate Tax

We are cognizant of the fact that the Committee report of the Ways and Means Committee of the House of Representatives states the following:

"Other income tax problems have had to be postponed for further analysis and study. Moreover, your committee found that the time available did not permit the inclusion of reform measures relating to revision of the estate and gift tax laws or the related problem of the tax treatment of property passing at death. Estate and gift taxes are an area of the tax laws your committee will undertake to study as soon as possible, with the expectation of reporting out a bill on this subject in this Congress."

However, we fail to understand how the most revolutionary tax reform legislation since the enactment of the Federal Income tax law can ignore and fail to deal with the problem of Federal Estate tax; especially as it affects the family-owned farming operation or a closely-held business.

As we indicated earlier, long overdue legislation has been introduced in both Houses to correct this tax inequity, in the House by Congressman Price and in the Senate by Senator Dole.

The present inheritance tax laws were enacted in the emotion-laden depression years when men were selling apples in the streets at a time when a few heirs and heiresses came into their inheritances which they proceeded to flaunt with worldwide publicity. Thus, the legislation was to prevent this from happening in the future.

But the result has been that the extremely wealthy have developed means of escaping the full impact of the law while the closely-held business and the family farm, the backbone of the middle-class, bears the brunt.

There is a distinct area of discrimination in the valuation of an estate that is comprised of a business or a farm and one that is comprised of publicly traded stocks and securities, the Texas Congressman maintains. While in an estate consisting of stocks, the earning power of the shares are the basis for valuation, on business enterprises or farms the value is placed on the presumed market value of the property with no attention given to whether or not speculation has substantially and unrealistically inflated the going price.

We therefore respectfully request that this Committee include in the Tax Reform Act of 1969, the provisions of Congressman Price and Senator Dole. The American family-held farm needs this tax relief if we are to maintain the family farm structure in American Agriculture and aid, not obstruct, young farmers continuing in agriculture.

VI. Conclusions and Recommendations

The tax structure should be so constituted as to fall as equally as possible on all individuals and all segments of the economy according to the income and resources of each. Accordingly, no individual or industry should enjoy unduly favorable or unreasonable advantages nor should any industry or individual be penalized by unfair tax levies or regulations.

It is generally recognized that deficit financing is a prime cause of inflation at the Federal level and jeoparidzes the ability of state and local governments to meet the needs of their areas in

the future. We, therefore, reaffirm our position favoring a balanced Federal budget at the earliest possible time.

We urge the Congress to review the budget with the purpose of reducing the budget deficit by eliminating or modifying programs not absolutely essential to the economy and immediate welfare of the nation. If budget reductions thus effected are not sufficient to relieve the inflationary pressures now threatening the welfare of the nation and its citizens, then we favor a surtax levy to decrease the pressures that are resulting in high interest rates and serious and damaging inflation. These steps are necessary to avoid wage and price controls which are not consistent with our free enterprise system and a growing and expanding economy.

The Grange believes there definitely is merit and justification for mineral depletion allowances. However, it is our opinion that present legislation and regulation in this regard should be carefully reviewed.

Remove the tax-exempt status for industrial development bonds issued by state and local governments.

No favored property tax treatment for religious, educational, fraternal or eleemosynary institutions on their property held for enterprises conducted primarily for profit in competition with tax-paying private enterprises.

As it becomes apparent that reductions in revenues received from Federal income taxes may be justified by reasons of reduction in expenditures, the means employed in achieving such reductions should include: (a) elimination of the recently-enacted income surtax; and (b) a substantial increase in the personal exemption of individual taxpayers for themselves and their dependents. The present exemptions

provide less than half the "buying power" that they did when they were incorporated in the Code.

It is one of the basic precepts of our legal system that a person is innocent until proven guilty; however, in cases involving the Internal Revenue Service, a person is, in effect, guilty until proven innocent. Therefore, the Grange favors legislation which would place the burden of proof on the Internal Revenue Service whenever that agency takes action against a taxpayer.

The National Grange would also like to go on record at this time in favor of the 6 months' continuation of the surtax at 5% or more after December 31, 1969 -- if the nation's economy is still superheated and that in addition to taxation, every means be used, short of Federal controls on prices and wages, to slow down and level off the nation's economy.

Mr. Chairman and Members of the Committee:

I am Robert M. Frederick, Legislative Representative of the National Grange, with offices at 1616 H Street, N. W., Washington, D. C. The National Grange is a farm and rural-urban community and family organization, representing 7,000 community Granges located in rural America. Our membership lives in rural-urban areas in 40 of the 50 States and has a vital interest in the legislation being considered by this Committee. Our interest in tax legislation has continued over a period of 102 years.

In a general sense, we support H.R. 13270, a bill to reform the income tax laws, to the extent that the provisions of the bill conform to Grange tax policy. However, there are several provisions of H.R. 13270 with which we are in total disagreement. We would like to take the time allotted us to discuss with the Committee the changes which the Grange believes should be made.

The most glaring differences between the position of the Grange and H.R. 13270 are in the following areas: (1) tax-loss farming; (2) hobby losses; (3) holding period for livestock; and (4) cooperatives' tax treatment.

In addition to these areas, there exists in present tax law an inequity in the Federal inheritance tax apparently not dealt with in H.R. 13270. We believe a corrective provision should be included in any tax reform bill. Corrective legislation has been introduced by Senator Robert Dole of Kansas and Representative Robert Price of Texas.

With the Committee's permission, we would like to discuss briefly each of these areas, and in some instances to point out what we think are better alternatives to the provisions of H.R. 13270.

Taking up in order the areas which we have enumerated, let me comment first on the question of tax-loss farming.

H.R. 13270 undertakes to correct a situation in which some high-income taxpayers not primarily engaged in farming have used farm losses to obtain a deduction in their high-bracket nonfarm income.

To do this, H.R. 13270 attempts to provide that a gain on the sale of farm property is to be treated as ordinary income, rather than capital gains, to the extent of the taxpayer's previous farm losses.

The taxpayer would have to maintain an excess deductions account to record his farm losses. In the case of individuals, farm losses would be added to the excess deductions account only if the taxpayer had income from nonfarm sources of more than $50,000 for the year, and only to the extent that the farm loss for the year exceeded $25,000.

In our judgment, the E.D.A. account approach does not strike at the heart of the "tax-loss" farming loophole. It only postpones the issue and strikes at all farmers, big and small, bona fide as well as the investor who is investing in agriculture for a profit. In doing so, it includes the "tax-loss" tax-dodging farmer. In referring to the latter, we use the word "farmer" rather loosely.

It is our firm belief that the provisions of the Amendment No. 139 introduced by Senator Metcalf on August 13, 1969 will correct the abuse of the liberal tax rules provided in the Internal Revenue Code for the use of bona fide farmers. Therefore, we respectfully urge that Amendment No. 139 be inserted in H.R. 13270 in place of part of Subtitle B - Farm Losses, etc., starting at line 10, page 139 of the bill and striking all that follows through line 6 on page 152.

In effect, what we are suggesting is the adoption of Amendment No. 139 in place of the House bills E.D.A. approach to solving tax-loss farming.

In our judgment, this method will be more in line with true tax reforms in providing more revenue for the Federal Treasury, a shifting of the tax burden and expediting the closing of tax loopholes that allow revenue losses.

It is our understanding that the E.D.A. and other farm tax proposals of the House bill will only apply to an additional 3000 persons and bring into the Federal Treasury an additional $25 million by the year 1979, such increase to come from correction in the tax-loss farming, depreciation recapture, holding period for livestock and a negligible amount from hobby-farm losses.

The amendment proposed by Senator Metcalf, Amendment No. 139, would apply to 14,000 taxpayers, thereby shifting the tax burden and would bring in an additional $205 million per year as soon as the bill became effective. In our opinion, this is true tax reform, because it increases Federal revenue at the same time it shifts the tax burden and the effect is immediate, and as we pointed out earlier in our testimony, it hits at the "jugular vein" of the tax-dodge farming.

This corrective amendment will affect only non-farmers with large amounts of nonfarm income who invest in farming to obtain tax losses.

There are numerous safeguards in the amendment to protect the family farmer who depends upon his farm to produce a living for his family.

Senator Metcalf has explained that he considered the E.D.A. approach when he first began to look into ways to correct the tax-dodging farm problem. In remarks before the Senate August 13, he said

"After a great deal of technical discussion with experts, I was convinced that the most effective way to get at this problem without hurting the legitimate farmer would be to take the loss limitation approach. Under this method, a dollar limit would be placed on the amount of artificially created farm losses that could be used as an offset against nonfarm income in any given year."

Amendment No. 139, as introduced by Senator Metcalf, is identical to S. 500, the legislation introduced by Senator Metcalf and 26 other Senators and endorsed by all major farm organizations and many of the commodity groups, plus many other trade associations.

The family farm structure in American agriculture must be given an even break with others engaged in agriculture for profit. It is our opinion that Amendment No. 139 will give us equality of income tax treatment and preserve for agriculture the liberal provisions of the Internal Revenue Code that were meant for farmers who farm for a livelihood.

It is the opinion of the National Grange that the provisions of Amendment No. 139 meet the needs of the American farmer far better than the first part of Subtitle B of H.R. 13270, thereby making any further changes in the Internal Revenue Code pertaining to agriculture unnecessary.

This corrective amendment will affect only non-farmers with large amounts of non-farm income who invest in farming in order to obtain tax losses which may be set off against their non-farm income.

There is an important exception to the dollar limitation in the amendment introduced by Senator Metcalf. This amendment in no event prevents the deduction of farm losses to the extent they relate to

taxes, interest, casualty losses, losses from drought, and losses from the sale of farm property. An exception is made for those deductions. In general they are deductions which would be allowed to anyone holding property without regard to whether it was being used in farming or because they represent deductions which are clearly beyond the control of the farmer, such as losses from casualty and drought.

Under provisions of the amendment, if the total of these deductions is higher than fifteen thousand dollars, then the higher figure may be used without any reduction because of nonfarm income above fifteen thousand dollars. In other words, the fifteen thousand dollar limitation is directed solely at the type of deductions that are artificially created through the abuse of the special accounting rules designed for ordinary farmers.

We are confident that the suggested amendment will not have a detrimental effect on legitimate farmers or non-farmers who invest in farming to earn farm profits. The amendment is unique, in that it is pointed directly at the abuse of the liberal tax accounting rules of the Internal Revenue Code, provided by Congress for ordinary farmers or those interests outside of agriculture that make investments in farming for a profit.

The amendment also provides for the large commercial farming interests in cattle, citrus and other farm specialty crops to be exempt from the provisions of the Act if they follow standard accrual accounting methods. Surely, such large privately-owned agricultural interests or investors in agriculture that use either grove management firms or cattle management firms have available to them the accounting expertise to follow such accounting methods.

The National Grange would be the last organization to support legislation to prohibit persons outside of agriculture from entering agriculture as full-time farmers or as investors supplying capital for those already engaged in agricultural production. We have insisted, however, and will continue to insist, that the rules for playing the game be the same. The adoption of Amendment No. 139 will equalize the rules and make farming a fair game for all interested in agriculture for profit.

Invasion by Conglomerates

We realize that the elimination of tax loopholes in the Internal Revenue Code as it applies to individuals and corporations investing or engaged in agriculture will not stop the conglomerate corporation invasion. It will, however, eliminate the financing of such mergers and take-overs by some taxpayers through the use of "tax shelter" windfalls

The real control over conglomerate corporate invasion can be done by tightening of the anti-trust laws, which we realize does not come under the jurisdiction of this Committee. However, we feel that this intrusion into agriculture is part of the same kind of problem which the Committee is considering today and perhaps is a far greater danger to the family farm structure of American agriculture. Curtailing tax abuse is the first step, and a necessary step, in controlling conglomerate corporation invasion of agriculture. We welcome this and similar tax legislation to take the "tax profit" out of such acquisitions by non-farm interests.

Benefits from Tax Shelters

We, as responsible members of the agricultural society, would be remiss if we did not consider any possible economic benefit to agriculture and rural America of the so-called "tax incentives" provided

in the Internal Revenue Code.

Those who are in opposition to plugging the Internal Revenue loopholes that permit "tax-loss" farming present the following arguments in favor of a continuation of the laissez faire:

1. They are not tax loopholes but are tax incentives to attract into agriculture outside "risk" money;
2. That outside capital investments in agriculture have assisted in improvement in livestock breeds;
3. That farmers have benefited by outside capital in that they can expand their operations, buy more cattle, more land, which in turn benefits rural America.

We cannot help but agree that outside capital has benefited certain individuals in agriculture as well as certain specific rural communities. However, we hasten to ask, is it worth the total cost to the Federal Treasury of approximately $205 million in lost revenue? The total increase in Federal revenue would be much higher since farm operations carried on by corporations usually are not separately reported on the corporation tax return. Consequently, data concerning the number of corporations and revenue effect with respect thereto are not available.

Thousands upon thousands of family farms, the backbone of rural communities, are adversely affected by the activity of a small percentage of individuals who are lucky enough to have benefited directly from outside "risk" capital.

Improvement in livestock breeds has been and continues to be a major research function of our land grant colleges. These institutions are supported by public funds and devote time, money and labor into herd improvement by breeding as well as scientific feeding. We suggest

that those laboratories of animal research have made major contribution to breed improvement, feeding improvement and similar advancements in the livestock industry far in excess of contributions made from outside "risk" capital.

We submit to this Committee that the interest of American agriculture and rural communities will be best served if the family farm structure does not have to compete with a select few individuals who are deriving direct benefit from the loopholes in the Internal Revenue Code.

Three categories of people receive direct benefit from the abuse of the liberal provisions in the Internal Revenue Code created for the use of the ordinary farmer: the investor, the financial manager and the farmer who manages the livestock or agricultural crops in which outside risk capital is invested, this at a tremendous loss to the Federal Treasury and the further economic loss to the family farm structure that is dependent upon profit for its very existence. Gentlemen, can we afford this kind of "Cowboy Economics"?

An Unwholesome Trend

The National Grange recognizes the importance of preserving and protecting the integrity of the owner-operator-manager farm, as a guarantee to the Nation of the efficient and abundant production of high-quality food and fiber at reasonable prices for the domestic and world market.

We seek to obtain for American farmers a return for their labor, management, risk and investment which bears a reasonable relationship to that received for those same economic factors in any other segment of our economy, as well as adequate compensation for their contribution to the general welfare.

The activities of conglomerate corporations and other non-farm interests in agriculture are not consistent with long-range Grange objectives and have resulted in commodity market price manipulation, unrealistically high prices for farm land and increased farm real estat taxes, (which have made it increasingly difficult to pass farms on to heirs). The net result has been a loss in rural America of farm families. These farm families are frequently forced to migrate to urban centers and into situations for which they are ill-prepared, which further aggravates the explosive problem of our central cities and urban areas, including flooding of the labor market with additional unskilled workers.

If large corporations and non-farm interests become predominant in agriculture, the need for many Main Street businesses, schools, churches and municipal facilities will be eliminated. It will destroy job opportunities in rural America and will not be in the best interest of long-term national objectives.

This impact on community life makes the non-agricultural corporate farm invasion a human as well as an economic problem. It is a problem that should concern all Americans and demand their immediate attention.

Incidentally, the Grange has a long history of interest in this problem. At the 73rd Annual Session of the National Grange, held in 1939 in Peoria, Illinois, the Delegate Body adopted the following resolution:

> "In order to discourage corporation farming and capitalists acquiring large acreage of farm land, we recommend that the Federal income tax be amended to provide that losses on agricultural operations can be deducted only from incomes derived from agricultural operations."

The policy of the National Grange, adopted 30 years ago, was a lone voice against the inequities contained in the Internal Revenue Code. The continuing validity of this objective has been subsequently recognized by action of the Delegate Body taken in 1963, 1964, 1965 and again in 1967, at the 100th Anniversary of the founding of the National Grange.

At our 102nd Annual Session held in Peoria, Illinois, in November 1968, as we started our second century of service to rural America, the Delegate Body once more reaffirmed Grange position on this important and vital matter of great concern to family farms and rural communities.

The Taxation and Fiscal Policy Committee that considered tax revision resolutions made the following statement:

"The mounting concern of the family farm operator over the accelerating acquisition of agricultural lands by individuals and organizations for the purpose of building up a loss position from farming operations conducted on the lands acquired and deducting such losses from income tax liability is indicated by the fact that resolutions to prevent this practice have been received at this Annual Session of the National Grange from eighteen of the 38 State Granges.

"Farmers and their families engaged in bona fide farming operations are being forced to leave the farm, as a result of net income being at a depressed level.

"Competition of non-farm investors inflating the price of agricultural land and using loss on farming operations as a deduction against non-farm income is a factor in this lower net farm income.

"Resolved, that the National Grange vigorously support

amending the Internal Revenue Code to prohibit any substantial portion of farm operating losses being used as a tax deduction or write-off against non-farm income."

Hobby Losses

We believe that if the Metcalf amendment is adopted by this Committee there will be no need to make further provisions in the law for the so-called "hobby farmers".

As stated by Senator Metcalf before the Senate on August 13, 1969 when he introduced his amendment, "...The loss limitation approach would include the hobby loss farmer and would limit the current deduction of his farm losses."

There exists the mistaken impression that H.R. 13270 would discourage hobby farming to a greater extent than the amendment introduced by Senator Metcalf. In the opinion of the author and the Grange, this is not the case.

The Grange is not against any individual having a hobby, be it farming or wood craft; we only want fair and equitable tax treatment and to ask that such a hobby not be used as a tax dodge. We feel that the Metcalf amendment does just this.

Holding Period for Livestock

Previously, livestock for draft, dairy or breeding purposes had to be held one year to qualify for long-term capital gains treatment, while other capital items had to be held only six months. Conformity has been reached by requiring all capital items to be held at least one year before qualifying for long-term capital gains. However, this provision will still discriminate against many raised farm animals by increasing the holding period for them, in some cases to periods in excess of three years, or three times the general holding period.

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In H.R. 13270, livestock for dairy, draft or breeding purposes are discriminated against in only this one major provision. It requires that such animals be held for at least 365 days after such animals would have first been used for such purpose. There is no similar provision for other personal property, such as machinery. Basically the requirement is that the item not be held for customers in the ordinary course of business.

We do not believe that the tax rules should be made more stringent against the farm industry at a time when it is undergoing severe economic problems. We therefore believe that the same rules regarding holding period for capital gains should apply to livestock.

This can be accomplished by striking the following in lines 7 and 8 on page 153, "for at least 365 days". Lines 7 and 8, page 153, would then read "but only if held by him after such animal normally would have first been used for any of such purposes."

In our judgment, this would more completely bring the treatment of livestock in line with the treatment of other property used in a trade or business.

We realize that one of the problems of our proposal would be one of intent. However, we believe our proposal fully meets the necessary requirements in this respect. In essence, under our proposal, until an animal became a draft, dairy or breeding animal, it would not qualify for long-term capital gains treatment. Once it had reached such status (draft, dairy or breeding) it would clearly show that this was the intent of its owner and that he was not primarily holding it for sale to customers in the ordinary course of business.

Cooperative Tax Revisions

The National Grange was shocked to learn of the proposed changes in co-op tax treatment contained in H.R. 13270 as passed by the U.S.

House of Representatives and now pending in the tax reform legislation before this Committee. Quite frankly, we do not see that co-op tax treatment has any connection whatsoever to "tax reform", the announced reason for holding these very hearings.

In our opinion "tax reform" should meet the following tests: (1) increase revenue to the Federal Treasury; (2) expedite the collection of the tax; and (3) shift the tax burden to those who are not carrying their share of the tax burden from those who are presently paying more than their proportionate share. The cooperative tax treatment in H.R. 13270 meets none of these tests.

We followed each press release of the House Ways and Means Committee regarding tax measures to be heard by the Committee and not once did we find the subject of co-op tax treatment listed as a subject for discussion. Therefore, neither we nor any other farm organization was permitted the privilege of open debate on such an important matter to agriculture as the tax treatment of farm co-ops, that was accorded the anti-co-op lobbyists who were permitted to have the subject introduced during the closing days of the executive hearings of the House Ways and Means Committee.

Our last-ditch efforts in the Ways and Means Committee were successful only in extending the time in which small co-ops will be permitted to live and serve agriculture and rural America. Such hasty action on a subject of vital concern to the lifeblood of all small co-ops can have a devastating effect and completely wipe out many such co-op marketing organizations. In attacking the "giants", the "Davids" will also be slain, quite contrary to the Biblical story.

In 1962, the same anti-co-op lobby was successful in writing into the tax code the requirement that the tax must be paid on dividends

earned by the patron for or by his patronage. At that time the Internal Revenue Code called for at least 20% of such dividend to be paid in cash so as to provide to the patron the money to pay the income tax on the dividend. The remainder could be retained in the capital structure of the co-op.

The proposal now before you, although it is a compromise, still means slow death to the small-to-medium farm cooperatives, especially those that have been organized less than 5 years.

Farmers will lose another measure of the right to say how their own businesses are to be run unless Sec. 531 is deleted from H.R.13270.

The proposal would dictate the amount of a cooperative's earnings that must be returned to a farmer in cash each year. It also would state when the remaining patronage refund certificates must be redeemed. Refunds not paid in accordance with the new requirements would be subjected to a current corporate federal income tax.

The borrowing power of farmer-owned businesses will be jeopardized if the proposed restrictions on cooperative financing are allowed to remain in the Tax Reform Act of 1969.

We would all agree it is desirable that the farmer receive as big a cash refund as possible, as quickly as it can be paid. This already is being done. Farmers, through an elected board of directors, decide each year what amounts they can take in cash and what amounts they must defer in order to provide capital for the cooperative.

But the proposed new regulations would take that decision away from the farmer and instead write a 15-year limit into law. This would put a "due date" on the farmer's investment in the co-ops and change the nature of that investment from "equity" to "debt capital". This could completely disrupt the capital structure of the cooperative and

impair its ability to borrow money.

The 15-year payout provision is one of the least-understood yet potentially the most damaging of the new rules being proposed for cooperatives.

The co-op tax provisions of H.R. 13270 completely ignore the role farm cooperatives play in improving the incomes of farmers by providing them with alternative methods of marketing their crops or of purchasing farm equipment, machinery and other farm supplies at reasonable prices.

Also, as pointed out in the "Summary of H.R. 13270, The Tax Reform Act of 1969" prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, "There is no showing that the present balance between farm cooperatives and regular businesses should be upset to the detriment of the cooperative movement."

The cooperative movement in the United States has had the encouragement and support of every Administration as far back as President Theodore Roosevelt, who stated:

"Wherever farmers themselves have the intelligence and energy to work through cooperative societies, this is far better than having the state undertake the work. Community self-help is normally preferable to using the machinery of government for tasks to which it is unaccustomed."

President Nixon at the start of his Administration stated:

"Some of the things that will be done in my Administration to help farmers include:

"--encouragement of farmers to improve their bargaining positions through their cooperatives,

"--assistance to farm cooperatives, including adequate

funding of the rural electric and telephone programs...

"--Improvement of credit programs within the Farm Credit System and the Department of Agriculture to meet the capital requirements of modern agriculture, especially young farm families trying to get a decent start..."

Secretary of Agriculture, Clifford Hardin, in addressing the annual meeting of the American Institute of Cooperation, in Urbana, Illinois on August 4, 1969, stated:

"Cooperatives are a positive and dynamic force in rural development. They have proved themselves an effective instrument in helping farm families make more effective use of their agricultural resources. Many cooperatives are also providing the original impetus for new community enterprises. In some communities the cooperative is the area's biggest industry.

"But cooperatives can, and must, do more, not only to increase job opportunities and income, but to be a positive force in helping local communities initiate and carry out new development projects."

We suggest to this Committee that cooperatives cannot aid farmers or rural America if they are "bled" to death by such measures as contained in Sec. 531 of H.R. 13270.

All farm leaders agree that more income for farmers should be the objective of any national program, taxation or farm policy. Our ideas on how to achieve this objective may differ us to farm policy, but not on co-op tax treatment.

Official figures buttress our case. They show, for example --

. That the income of farm families is about 75 percent as much as that of nonfarm families.

. That prices paid by farmers increased 28 percent from 1957-59 to mid-1969, compared with a 17 percent rise in the overall

consumer price index and a 24 percent increase in retail food prices.

. That food prices have risen only two-thirds as much as those of all other consumer goods in the past 10 years.

. Agricultural output per man-hour increased 82 percent between 1957-59 and 1968.

. One farm worker in 1967 supplied the needs of 43 people compared with 23 in 1957-59.

. Farmers in recent years have increased their productivity by 5.3 percent, a rate twice that of industry.

To date we, as producers of this abundance of food and fiber, have not shared in the benefits of our labors. Farm cooperatives are one way and perhaps the best way that farmers can increase their economic position in relationship to other segments of our society -- and now this avenue of economic improvement is being threatened by so-called "Co-op Tax reforms". The destruction of cooperatives appears to be the only purpose of the measure as it would deny cooperatives the same right to use their earnings for legitimate business purposes that corporations have had from the beginning of corporate history.

It's too bad that we must once again be asking busy Senators to devote time to a matter which seemingly was settled in 1962 after lengthy hearings and debate. Here you are confronted with what has been called the most sweeping tax reform measure in history. And among the many sections is a measure which has nothing to do with tax reform; which would not yield any additional tax revenue nor any additional tax benefit; but which could greatly restrict the growth of farmer cooperatives.

We see no justification for new laws governing cooperative financing or taxation. We will urge -- in the strongest possible appeal -- that the entire section on cooperatives be deleted from the Tax Reform Act of 1969.

Federal Estate Tax

We are cognizant of the fact that the Committee report of the Ways and Means Committee of the House of Representatives states the following:

"Other income tax problems have had to be postponed for further analysis and study. Moreover, your committee found that the time available did not permit the inclusion of reform measures relating to revision of the estate and gift tax laws or the related problem of the tax treatment of property passing at death. Estate and gift taxes are an area of the tax laws your committee will undertake to study as soon as possible, with the expectation of reporting out a bill on this subject in this Congress."

However, we fail to understand how the most revolutionary tax reform legislation since the enactment of the Federal income tax law can ignore and fail to deal with the problem of Federal Estate tax; especially as it affects the family-owned farming operation or a closely-held business.

At the 102nd Annual Convention of the National Grange, held in Peoria, Illinois, on November 11, 1968, the Delegate Body adopted the following resolution:

"Federal Estate Tax

"WHEREAS, in suburban and rur-urban areas farm real estate is currently appraised for inheritance tax purposes on the value of the land for non-farm uses in the areas; and

"WHEREAS, a high appraisal value per acre for federal estate tax

purposes results in a burdensome levy upon those who wish to remain in farming; and

"WHEREAS, placing such high taxable values upon farms for either property or inheritance tax purposes is not a realistic approach and when applied generally to all farms in an area, it is a futuristic value concept which adversely affects the continuation of farming in areas of prime agricultural land and needed open spaces; therefore, be it

"RESOLVED, that we recommend that appraisals of farm real estate made for inheritance and estate tax purposes be made on the basis of agricultural use value."

Under present inheritance, or death tax laws, when the principal owner of a family, or closely-held, business approaches the end of his life span, a crisis results. Knowing on his death the business will be forced to pay an inheritance tax far in excess of any existing cash position, and often not even in line with its earning record, the usual procedure is to seek a merger to avoid liquidation.

The family head of a family-owned farming operation faces the same situation, inasmuch as today's inflated land and property values are not at all in line with the profitability of the enterprise, whether it be an independent business firm, or a farming operation.

As we indicated earlier, long overdue legislation has been introduced in both Houses to correct this tax inequity, in the House by Congressman Price and in the Senate by Senator Dole.

The Greeks did have a word for it -- Harpyiai -- which translates to "snatchers". The Greek word, subsequently anglicized to Harpies is apparently, in the opinion of many Americans, synonomous with the inheritance tax collector.

While we may not go that far, we do agree with Congressman Price of Texas' legislation to drive the Harpies away by ending what has been a major cause of mergers, as well as the liquidation of the family-held farm.

The bills by Congressman Price and Senator Dole would permit the value of an estate for inheritance tax purposes to be set, at the option of the executor, either on the basis of the deceased's costs, or on the basis of the profit of the enterprise as revealed by income tax returns.

Congressman Price cites the hypothetical example of a family-owned cattle ranch that under the present system of appraising at today's inflated values would be assessed at $300,000 leaving the inheriting son liable for $110,500 in taxes, according to his computations.

Using this hypothetical example, to further illustrate, the Texas legislator says the actual profit being realized is only $7,500. Thus, using a reasonable factor for determining value, the estate should only be valued at $105,000 which would result in a death tax liability of $22,500.

On top of the Federal death tax, most states also assess a similar tax, but usually the states will follow the Federal pattern.

Operation of the inheritance tax has and continues to create many problems which are probably more middle-class in nature than those of the very wealthy who have learned to use foundations and other loopholes to escape the full weight of the tax laws.

The present inheritance tax laws were enacted in the emotion-laden depression years when men were selling apples in the streets at a time when a few heirs and heiresses came into their inheritances which they proceeded to flaunt with worldwide publicity. Thus, the

legislation was to prevent this from happening in the future.

But the result has been that the extremely wealthy have developed means of escaping the full impact of the law while the closely-held business and the family farm, the backbone of the middle-class, bears the brunt.

Perhaps the comparison between this situation and Greek mythology is even more pertinent. In early ancient mythology Harpies were considered somewhat semibeneficial but in the later era of the Argonautic sagas Harpies had degenerated into foul and loathsome creatures. The inheritance tax appears to have followed the same course.

Whether or not Congressman Price and Senator Dole will be able to emulate Calais and Zetes who drove off the Harpies, remains to be seen. Not only must they secure support from fellow legislators, but they must also educate the less knowledgeable that the inheritance taxes are no longer a "soak the rich" device, but a powerful destructive force of the middle-class backbone.

There is a distinct area of discrimination in the valuation of an estate that is comprised of a business or a farm and one that is comprised of publicly traded stocks and securities, the Texas Congressman maintains. While in an estate consisting of stocks, the earning power of the shares are the basis for valuation, on business enterprises or farms the value is placed on the presumed market value of the property with no attention given to whether or not speculation has substantially and unrealistically inflated the going price.

We therefore respectfully request that this Committee include in the Tax Reform Act of 1969, the provisions of Congressman Price and Senator Dole. The American family-held farm needs this tax relief if we are to maintain the family farm structure in American Agriculture and aid, not obstruct, young farmers continuing in agriculture.

Conclusions and Recommendations

It is the opinion of the National Grange that tax reform should be effected, but only in accordance with certain economic principles.

Recognizing that the economic policy of the Federal Government has a direct and important impact on the economy of the nation and affects all citizens, it is essential that these policies be sound and in keeping with the obligations of the various units of government and the services rendered by the respective units of government.

The tax structure should be so constituted as to fall as equally as possible on all individuals and all segments of the economy according to the income and resources of each. Accordingly, no individual or industry should enjoy unduly favorable or unreasonable advantages nor should any industry or individual be penalized by unfair tax levies or regulations.

It is generally recognized that deficit financing is a prime cause of inflation at the Federal level and jeopardizes the ability of state and local governments to meet the needs of their areas in the future. We, therefore, reaffirm our position favoring a balanced Federal budget at the earliest possible time.

We urge the Congress to review the budget with the purpose of reducing the budget deficit by eliminating or modifying programs not absolutely essential to the economy and immediate welfare of the nation. If budget reductions thus effected are not sufficient to relieve the inflationary pressures now threatening the welfare of the nation and its citizens, then we favor a surtax levy to decrease the pressures that are resulting in high interest rates and serious and damaging inflation. These steps are necessary to avoid wage and price controls which are not consistent with our free enterprise

system and a growing and expanding economy.

The following tax reforms are recommended by the Grange:

1. We appreciate the steps that have been taken to simplify the tax report form. Further change and simplification, we believe, can have the effect of making reporting easier for the taxpayer, and will result in more exact reporting. An easy-to-understand form will also benefit the government by bringing more accurate reports and thus save on auditing costs as well as the expense of refunds and billing.
2. The Grange believes there definitely is merit and justification for mineral depletion allowances. However, it is our opinion that present legislation and regulation in this regard should be carefully reviewed.
3. The Grange approves of giving the farmer the option of choosing limitation of losses that are deductible or reporting his farming operations on an "accrual accounting" basis, but we oppose any action that would mandate that farmers report to the I.R.S. on an accrual basis.
4. Remove the tax-exempt status for industrial development bonds issued by state and local governments.
5. No favored property tax treatment for religious, educational, fraternal or eleemosynary institutions on their property held for enterprises conducted primarily for profit in competition with tax-paying private enterprises.
6. As it becomes apparent that reductions in revenues received from Federal income taxes may be justified by reasons of reduction in expenditures, the means employed in achieving such reductions should include: (a) elimination of the recently-enacted income surtax; and (b) a substantial in-

crease in the personal exemption of individual taxpayers for themselves and their dependents. The present exemptions provide less than half the "buying power" that they did when they were incorporated in the Code.

7. The Grange does not favor sharing Federal income tax with the states. It is the opinion of the Grange that there is little to be gained by having the Federal Government collect taxes for blanket re-distri ution to the state governemtns, and therefore we recommend the policy of special appropriations by the Congress to care for any necessary sharing in state financial difficulties.

   We believe that the present distribution and control of Federal funds coming into states for specific community development or similar projects should be free of Federal control. These funds, according to Grange policy, should be placed under the control of state, county or local units of government and be used for the specific programs designated in the allocation of the funds.

   Until permanent and equitable "in lieu of tax" legislation is enacted, the Grange recommends that present law be amended to provide that states shall receive a percentage of gross, rather than net, income from sales, rentals and other revenue from national forest lands.

8. It is one of the basic precepts of our legal system that a person is innocent until proven guilty; however, in cases involving the Internal Revenue Service, a person is, in effect, guilty until proven innocent. Therefore, the Grange favors legislation which would place the burden of proof on the Internal Revenue Service whenever that agency takes

action against a taxpayer.

Innocent people have found it necessary to wage costly court battles in order to defend themselves from unfounded charges by the Internal Revenue Service. This has caused them to suffer severe financial hardship through no fault of their own and is unjust and inconsistent with the stated principles of our society.

Therefore, the Grange favors legislation which will make the Internal Revenue Service financially responsible (at the discretion of the courts) for the legal costs of any cases which are decided against them.

The National Grange supported the immediate passage of the ten-percent surtax when it was before this Committee believing that it would be followed by meaningful and equitable general tax reform legislation. We now respectfully urge that this Committee, as soon as possible, while making the necessary corrections in H.R. 13270, as requested by us and other witnesses appearing before this Committee, report to the floor of the Senate the best and most progressive Tax Reform Bill in history and work with the Senate leadership to enact such legislation into law before the end of this Session of the 91st Congress.

The National Grange would also like to go on record at this time in favor of the 6 months' continuation of the surtax at 5% or more after December 31, 1969 -- if the nation's economy is still super-heated and that in addition to taxation, every means be used, short of Federal controls on prices and wages, to slow down and level off the nation's economy.

Agriculture can never hope to walk side by side with other segments of the nation's economy as long as we have inflation eating up

the small gains we are able to obtain through agricultural program planning, export marketing and increased efficiency of the commercial family farm.

We thank this Committee for the many hours they will have to spend to bring forth a tax reform act that meets the needs of our nation. We especially thank the Chairman for his leadership in tax legislation and respectfully urge early action on tax reform legislation.

Thank you, Mr. Chairman, for permitting the National Grange to present its views on this most important matter.

FARM CREDIT ADMINISTRATION
WASHINGTON, D.C. 20578

IN REPLY REFER TO:

September 12, 1969

Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

On behalf of the 13 banks for cooperatives and the Federal Farm Credit Board, I request the attached statement be given favorable consideration by your Committee in its deliberation on H.R. 13270, the Tax Reform Act of 1969.

Our request is only for clarification of the tax treatment of the 13 banks for cooperatives. We believe this could be accomplished through the addition of three sentences to the report that will be issued by the Committee on H.R. 13270.

The specific language suggested for that report is included in the attached statement under the heading, "Summary of Proposal."

The first sentence is introductory.

The second sentence is intended to assure that the additions to the bad-debt reserve accounts by the banks for cooperatives be treated in the same manner as those of commercial banks whenever the banks for cooperatives have repaid the investment of the Government and become subject to Federal income tax.

The third sentence suggested for the report would confirm the position of Congress that a small part (over the years it has averaged less than 5 percent) of gross income of the banks for cooperatives should be accepted as patronage income for income tax purposes, which was clearly the intent of Congress as stated in the legislative reports and history when Public Law 88-528 was considered in 1964.

We appreciate your consideration.

Sincerely,

E. A. Jaenke
Governor

Attachment

33-758 O-69—No. 8—23

FARM CREDIT ADMINISTRATION STATEMENT
submitted to
Senate Committee on Finance
in connection with
Section 441 of Tax Reform Act of 1969
(H.R. 13270, 91st Congress)
September 12, 1969

Summary of proposal

In view of the specific provision in section 441 of H.R. 13270 as to the deduction to be allowed commercial banks generally for Federal income tax purposes, for additions made to a bad-debt reserve, and the scope of the Tax Reform Act of 1969 in other respects, the Farm Credit Administration urges that there should also be clarification of the Federal income tax treatment of the 13 banks for cooperatives which operate under its supervision:

First, to assure that the banks for cooperatives, each of which first became subject to Federal income tax when it recently retired all of its Government capital, and whose loans are similar to the loans made by commercial banks generally, may be allowed a deduction for annual additions to a reserve for losses on loans which does not exceed that allowable to commercial banks generally for taxable years before the tax reform bill becomes effective; and

Second, to assure that a deduction may be allowed for the full amount of patronage dividends paid by a bank for cooperatives, so far as concerns such amount representing net earnings from business done with or for borrowers from the bank, in accordance with the intention indicated by the congressional committees which in 1964 recommended enactment of Public Law 88-528 to amend the Farm Credit Act of 1933.

It is suggested that such clarification can be accomplished, even without specific amendment of the bill, by including something like the following in the report of the Senate Committee on Finance on the Tax Reform Act of 1969:

The Committee considered two aspects of the Federal income tax treatment of the 13 banks for cooperatives, which operate under the Farm Credit Act of 1933 and the supervision of the Farm Credit Administration to make loans to farmer cooperatives, and is of the view that there can be clarification without additional legislation. Because of the similarity of the loans made by the banks for cooperatives and the loans made by commercial banks generally, it is considered that a bank for cooperatives for the years since it recently became subject to Federal income tax may and should be allowed an annual deduction for additions to a bad-debt reserve as is allowable

for commercial banks generally under Revenue Ruling 65-92 while* that ruling continues applicable. Further, the Committee believes that the relatively insignificant portion of patronage dividends paid by a bank for cooperatives which is from temporary investments rather than interest collected on loans may and should be accepted as from business done with or for the farmer cooperatives that borrow from the bank, in accordance with the intention heretofore indicated in connection with the enactment of Public Law 88-528 (Sen. Rep. No. 1453, H.R. Rep. No. 1368, 88th Cong., 2d Sess.).

Banks for cooperatives

The 13 banks for cooperatives, one in each of the 12 farm credit districts and a Central Bank in the District of Columbia, were established under the Farm Credit Act of 1933 to make loans to eligible farmer cooperative associations engaged in marketing farm products, purchasing farm supplies, or rendering farm business services. The loans are made with funds obtained by selling the consolidated debentures of the banks in the public securities market. The lending is on a self-sustaining basis; and each bank is required to operate on a cooperative basis for the benefit of the farmer cooperatives which borrow from the bank and now own its capital stock, and without profit to anyone else.

Each of the 13 banks for cooperatives was started with capital stock owned by the United States and became subject to Federal income tax only after all of its Government capital was retired: Two each year on June 30 of 1965, 1966, 1967, and 1968; and the other five on December 31, 1968. The first year for which a bank for cooperatives is subject to Federal income tax, therefore, is the year after all of its Government capital was retired.

Further information about the banks for cooperatives will be included as may be helpful in the separate explanation of the two deductions, and the desired clarification of each, which now follows.

Bad-debt reserve deduction

As developed in more detail later under this heading, the similarity of loans made by a bank for cooperatives to loans made by a national or other commercial bank, has been considered to entitle a bank for cooperatives to the same Federal income tax treatment as is allowed such other banks for annual additions made to a reserve for losses on loans. The basic statutory provision is section 166 of the Internal Revenue Code which allows "a deduction for a reasonable addition to a reserve for bad debts" (in lieu of a deduction for debts which become worthless). In 1965, Revenue Ruling 65-92 (C.B. 1965-1, 112) in effect specified the annual deduction which would be allowed commercial banks for additions to a bad-debt reserve, until the accumulated reserve equals 2.4 percent of outstanding loans. Section 441 of H.R. 13270 would cut back the deduction allowed commercial banks for

additions to bad-debt reserve and base it on the ratio of losses to outstanding loans for the current year and the 5 preceding years. However, whatever provision in this respect is included in the tax reform bill as finally enacted, it is urged that a bank for cooperatives should be allowed a deduction for annual bad-debt reserve additions which does not exceed that provided in Revenue Ruling 65-92 for commercial banks generally for the years that ruling is applicable.

By its terms, Revenue Ruling 65-92 is applicable only to "banks", as therein defined, "a substantial part of the business of which consists of receiving deposits and making loans and discounts". Although the banks for cooperatives make loans and discounts, their business does not include receiving deposits. Because of this, Revenue Ruling 65-92, by its terms, is not applicable to a bank for cooperatives. Thus far, too, the Internal Revenue Service has not seen fit to broaden Revenue Ruling 65-92 to include banks for cooperatives; or to apply a similar ruling to them; although either course is considered to be within the present statutory authority of the Internal Revenue Service to allow a deduction for a "reasonable" bad-debt reserve addition. In any event, as developed in the next three paragraphs, the loans made by the banks for cooperatives are of the same general character as those made by commercial banks, and such similarity is considered to warrant a deduction for annual additions to a bad-debt reserve which does not exceed that allowed commercial banks generally under Revenue Ruling 65-92 for the years that ruling is applicable.

Under the Farm Credit Act of 1933, as amended, the banks for cooperatives are authorized to obtain loan funds by selling their consolidated debentures in the public securities market (12 U.S.C. 1134m) and to make loans to cooperative associations as defined in the Agricultural Marketing Act, as amended (12 U.S.C. 1134c). The types of loans made by a bank for cooperatives are generally indicated by the following from the Agricultural Marketing Act definition of a farmer cooperative association to which such loans may be made (12 U.S.C. 1141j):

> . . . the term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services . . .

A bank for cooperatives makes loans for all of the foregoing purposes. This includes seasonal loans (usually payable within 12 months) to help finance inventories of farm products and supplies for farm production, receivables, and operating expenses. It also includes term loans (payable over more than 12 months, but ordinarily not in excess of 20 years) to help finance construction of physical facilities and purchase of equipment required by the cooperatives to render needed services for their members.

At June 30, 1969, the banks for cooperatives were financing 2,955 farmer cooperatives with total loans outstanding of $1.6 billion. The average amount of loans outstanding to a borrower at that time was $540,000. About 78 percent of the 2,955 accounts had loans totaling $300,000 and under. However, 22 percent of the number had 87 percent of the loan volume outstanding. Studies by the U. S. Department of Agriculture have shown that the banks for cooperatives provide about 60 percent of the credit used by farmer cooperatives in the United States.

Commercial banks make the same types of loans to both private and cooperative corporations with similar security and repayment provisions. However, commercial banks, in financing a wide diversity of individuals and businesses, avoid the risks of lending to a single industry. Opportunity for such loan portfolio diversification and risk diminution is not available to the banks for cooperatives.

In the circumstances, it is urged that the Committee may see fit to indicate, in its report on the tax reform bill or otherwise, that it sees no objection to a bank for cooperatives being allowed a deduction for annual additions to a bad-debt reserve which does not exceed that provided under Revenue Ruling 65-92 while that ruling is applicable as to commercial banks generally, for any year that a bank for cooperatives is subject to Federal income tax. This is all the more deemed reasonable because overall the total deductions claimed by the 13 banks for cooperatives for their taxable years thus far have actually been only about half of the deductions allowable under the revenue ruling for commercial banks generally.

Patronage dividend deduction

In its report on the tax reform bill or otherwise, it is urged that the Committee on Finance also express approval or recognition of the intention heretofore indicated by Congress in 1964, in connection with the enactment of Public Law 88-528, as to the deduction to be allowed for patronage dividends paid to its borrowers by a bank for cooperatives when it becomes subject to Federal income tax. The intention is that all of such patronage dividends should be accepted as from business with or for borrowers from the bank; and that the relatively insignificant amounts, if any, from temporary investments, need not be distinguished in this respect from the interest collected from borrowers on their loans. This intention was expressed in reports of the Agriculture Committees of Congress which in 1964 considered and recommended Public Law 88-528 inasmuch as it involved an amendment of the Farm Credit Act of 1933 to enable a bank for cooperatives to meet certain requirements of the Internal Revenue Code. To meet an objection that the intention was not heretofore before the Committees of Congress which have jurisdiction on tax legislation, the matter is now being presented to the Committee on Finance.

The Farm Credit Act of 1933, as amended in 1955, requires a bank for cooperatives, at the end of each fiscal year, to pay patronage dividends

to the farmer cooperative associations that are borrowers from the bank (12 U.S.C. 1134l). All patronage dividends are paid in the proportion that the amount of interest earned on the loans of each borrower bears to the total interest earned on the loans of all borrowers during the fiscal year. From 1955 to 1964, the Farm Credit Act required such patronage dividends to be in surplus account allocations and class C stock, and there was no authority to pay patronage dividends in money.

In 1964 the intention of each bank for cooperatives was to complete retirement of its Government capital within the next several years after which it would be subject to Federal income tax. It then would be necessary to meet the requirements of the Internal Revenue Code applicable to any corporation operating on a cooperative basis (subchapter T of chapter 1, §§ 1381-8), if the patronage dividends of a taxable bank for cooperatives were to qualify for deduction from gross income in computing taxable income. One of such requirements is that at least 20 percent of a patronage dividend be paid in money (§ 1388 (c) (1)). To meet this requirement, Public Law 88-528, approved August 31, 1964, added a sentence to the Farm Credit Act (12 U.S.C. 1134l (b), last sentence) which in effect requires a bank for cooperatives to pay such portion of its patronage dividends in money (presently 20 percent) as will permit its taxable income to be determined without including such patronage dividends.

What we are now concerned with, so far as concerns the patronage dividends of a bank for cooperatives qualifying for deduction, is the definition in the Internal Revenue Code to the effect that the patronage dividends should represent net earnings from business done with or for borrowers from the bank (§ 1388 (a) (3)). The banks for cooperatives exist only to make loans to eligible farmer cooperative associations, mostly with funds obtained by periodically selling their consolidated debentures in the public securities market. All of the earnings of a bank for cooperatives consist of interest collected on loans made to farmer cooperatives except that there are relatively insignificant earnings from funds on hand which may be invested in interest-bearing securities or loaned to other Farm Credit Banks temporarily. Inasmuch as each bank for cooperatives must keep on hand a sufficient amount of funds so that it at all times may be in a position to make loans as required in its district, it is considered that any earnings from the funds so held are no less from business done with or for the farmer cooperative associations that borrow from the bank than is the interest paid by such cooperatives on their loans. This is supported not only by the terms of the 1964 amendment to the Farm Credit Act, but also by the following from the reports of the congressional committees which recommended the 1964 amendment (Public Law 88-528) to the Farm Credit Act (Sen. Rep. No. 1453, p. 5, H.R. Rep. No. 1368, p. 4, 88th Cong., 2d Sess.):

> Another requirement of subchapter T, if the patronage allocations and refunds of a bank for cooperatives are to be deductible from its gross income in computing taxable income, is that the

> amounts involved shall come within the definition of a patronage dividend as that term is defined in subchapter T. One element of the definition is that such amounts come out of earnings from business done with or for patrons. In the case of a bank for cooperatives, practically all or at least as much as 95 percent of its gross income comes as a result of the loans made to the farmers' cooperatives that borrow from the bank. There also may be a very minor amount of income from securities in which a bank may invest and from temporarily surplus funds that it may have loaned to other banks of the cooperative farm credit system. These latter amounts are relatively insignificant and the intention is that it should not be necessary to distinguish them from the interest collected on loans insofar as concerns being derived from business with or for the borrowing cooperatives.

Thus far the Internal Revenue Service has not seen fit to acknowledge concurrence in such intention, presumably only because the 1964 amendment to the Farm Credit Act was recommended by the Agriculture Committees and was not then considered by the Committees of Congress which have jurisdiction of the tax provisions of the Internal Revenue Code. It is to meet this objection on the part of the Internal Revenue Service that the matter is offered for review by the Committee on Finance. Based on such review, it is hoped that the Committee on Finance may see fit to indicate that there is no objection to giving effect to Public Law 88-528, as to the deduction for the full amount of patronage dividends, in accordance with the intention indicated in connection with its enactment in 1964 (Sen. Rep. No. 1453, H.R. Rep. No. 1368, 88th Cong., 2d Sess.). Overall the amounts involved, as noted above, are no more than 5 percent of gross income; and in terms of net earnings or patronage dividends, the percentage involved is even less, if any.

Statement
of
E. A. Jaenke, Governor, Farm Credit Administration
submitted to
Senate Committee on Finance
in connection with
Section 531 of Tax Reform Act of 1969
(H.R. 13270, 91st Congress)
September 19, 1969

Summary

The Federal Farm Credit Board, which sets policy for the Farm Credit Administration, and the 13 banks for cooperatives consider it to be in the public interest that section 531 should be stricken from the tax reform bill.

The additional requirements which would be imposed by section 531 of H.R. 13270, in order to qualify patronage dividends of cooperatives generally for deduction in computing income subject to Federal income tax, would seriously impair the ability of both the 13 banks for cooperatives and the farmer cooperatives to which such banks make loans to serve farmers effectively.

The reasons for these conclusions follow:

(1) The increased money payment requirements of section 531 (from 20 to 50 percent with the remainder to be paid within 15 years) would present special problems for a bank for cooperatives which must operate as provided in the Farm Credit Act of 1933, as amended.

(a) Alternatively, the 30 percent increased money payment requirement of section 531 may be met by payment on qualified outstanding patronage dividends. However, the Farm Credit Act requires that the oldest outstanding patronage dividends be retired first, and those issued by a bank for cooperatives since 1956 and before it recently became subject to Federal income tax (between 1965 and 1969) are not qualified under the Internal Revenue Code.

(b) In the event of a year with net losses, the Farm Credit Act provides that they shall be absorbed by charges against or impairment of outstanding patronage dividends, which might make the amount payable thereon less than their value when issued. If this possibility were considered to preclude a bank for cooperatives from meeting the additional 15-year money payment requirement of section 531, it would mean that none of its patronage dividends, except those paid in money, could qualify for deduction.

(2) A general problem for all cooperatives, including a bank for cooperatives, under the 15-year money payment requirement of section 531, is whether their financial position in the year that the money payments are due, will be such that the payments can be made.

(3) The additional requirements imposed by section 531 would seriously impair both the financial strength and the debt repayment capacity of many farmer-owned cooperatives which borrow from a bank for cooperatives and they also would seriously impair the capacity of a bank for cooperatives to carry or make a loan to a farmer cooperative on a self-sustaining basis, particularly term loans.

Therefore, section 531 would greatly hamper farmers' efforts to build strong cooperatives or even maintain existing organizations that farmers designed to help themselves solve many of their own problems, as Congress has long encouraged them to do.

Scope of statement

Inasmuch as section 531 of H.R. 13270, the Tax Reform Act of 1969, would impose additional requirements on cooperatives generally, if their patronage dividends are to qualify for deduction from gross income in computing their income that is subject to Federal income tax, it concerns both the 13 banks for cooperatives, which operate under the supervision of the Farm Credit Administration in making loans to farmer cooperatives, and the farmer cooperatives which borrow from the banks for cooperatives. In the circumstances, after noting the additional requirements in section 531, this statement will undertake to review the application of those requirements to the banks for cooperatives and to the farmer cooperatives which borrow from the banks. Comment will also be made relative to the lending operations of the banks for cooperatives. Before doing so, though, it may be helpful to have in mind the present tax status of the banks for cooperatives.

Tax status of banks for cooperatives

The 13 banks for cooperatives are established under the Farm Credit Act of 1933 to make loans to eligible farmer cooperative associations as therein authorized; and since 1955, the Act requires that the banks themselves also operate on a cooperative basis, with the borrowing cooperatives investing in capital stock and surplus of the banks by retention of patronage dividends and by direct stock purchase. Such investments have been used during the past 14 years largely to retire Government stock. Each bank for cooperatives first became subject to Federal income tax when it retired all of its Government capital and, for each bank, this was during the period June 30, 1965, to December 31, 1968. The banks for cooperatives, therefore, are subject to the Federal income tax treatment provided in the Internal Revenue Code for organizations doing business on a cooperative basis, as are the farmer cooperatives which borrow from the banks.

Proposed amendment of Internal Revenue Code by section 531

(1) As passed by the House of Representatives, section 531 of H.R. 13270, the Tax Reform Act of 1969, would amend the Internal Revenue Code to change the Federal income taxation of organizations doing business on a cooperative basis, and their patrons, as respects patronage dividends (and per-unit retains) from a cooperative to its patrons.

(2) Under existing law, patronage dividends (and per-unit retains) which meet the specific requirements of the Internal Revenue Code to qualify for such treatment, are excludible or deductible from gross income in computing the taxable income of the cooperative, for the year for which paid, and are includible in the gross income of the patron for the year in which received.

(3) Section 531, as passed by the House, without increasing tax revenues in any respect, would impose additional requirements if patronage dividends (and per-unit retains) are to qualify for the foregoing tax treatment for taxable years beginning after 1969. One additional requirement, noted under (4) below, would apply only to patronage dividends; a second additional requirement, noted under (5) below, would apply to both patronage dividends and per-unit retains.

(4) One additional requirement would be to increase to 50 percent (from the present 20 percent at the rate of 3 percent each year for 10 years) the portion of annual patronage dividends to be paid in money in order to qualify them for deduction, although the added (up to 30 percent) money payment requirement could be met by payment on qualified patronage dividends issued for earlier taxable years.

(5) A second additional requirement, as to the remainder of annual patronage dividends or per-unit retains not already paid in money, would be (a) that the bylaws of the cooperative provide for payment of the remainder in money within the next 15 years, or (b) that an unconditional written evidence of indebtedness, to mature within the next 15 years, be issued for such remainder.

Application of proposed amendment (section 531) to a bank for cooperatives

If the present 20 percent money payment requirement in the Internal Revenue Code should be increased to 50 percent, as proposed in section 531, the increased money payment would also be required to be made by banks for cooperatives under the Farm Credit Act. Under the bill the additional 30 percent cash payout could be treated in one of two ways: (1) As current patronage refunds, or (2) to retire qualified patronage refunds resulting from earnings in prior years. As a practical matter the banks for cooperatives probably would not distribute the additional amounts as patronage refunds because of the underlying intent of the Farm Credit Act that new

capital inputs should be used to retire the oldest outstanding equities of cooperatives. Insofar as the alternative is limited to payment on qualified patronage dividends issued for earlier taxable years, there would be a special problem for the banks for cooperatives.

The Farm Credit Act requires that retained patronage dividends of the banks for cooperatives be issued in the form of allocations of surplus and class C stock. The Act also provides that after the retirement of all class A (Government) stock, class C stock also may be retired in money at par by the board of directors of a bank calling the oldest outstanding stock. When the surplus account of a bank exceeds 25 percent of total capital stock, the excess amount of allocated surplus may be distributed in the form of class C stock. However, it was only as each bank for cooperatives retired all of its Government capital and became subject to Federal income tax starting with the period June 30, 1965, to December 31, 1968, that a bank issued patronage dividends that qualified for deduction under the terms of the Internal Revenue Code. Accordingly, although section 531 would permit the additional 30 percent money payment requirement to be met by payment on outstanding qualified patronage dividends, the Farm Credit Act in effect requires that unqualified patronage dividends, issued since 1956 and before a bank for cooperatives became subject to Federal income tax, must be retired first.

Since the Farm Credit Act requires that retained patronage dividends of a bank for cooperatives be in the form of allocations of surplus account and class C stock, such patronage dividends cannot be issued in the form of an unconditional written evidence of indebtedness to mature within the next 15 years. Such banks can adopt a bylaw providing for payment of the remainder of its patronage dividends for years after 1969 within the 15 years after issue. However, such a bylaw would be subject to the provisions of the Farm Credit Act concerning allocated surplus and class C stock, and special problems occur under these circumstances.

First, the banks for cooperatives could have difficulty in meeting the 15-year limitation on retained patronage dividends. At the present time the revolving periods for the allocated equities vary by banks and range from 8 to 14 years. Four of the banks are at the 14-year level since they have just recently repaid all Government capital and have not yet had the opportunity to consider the retirement of their oldest outstanding capital held by cooperatives. There is no assurance that the amount of patronage dividends to be earned in future years will be sufficient to retire equities on a 15-year basis without weakening the financial structure of a bank. In such circumstances a bank might not be able to fully serve the needs of farmer cooperatives as intended by Congress.

Secondly, in the event of a net loss in the operations of a bank for cooperatives in any succeeding fiscal year, the Farm Credit Act requires that such loss be charged to allocated surplus and, to the extent not absorbed by surplus, to the impairment of class C stock. The above losses,

therefore, would reduce the amount of patronage dividends to be retired at a future date. If there are sufficient earnings in succeeding years, any impairment of the class C stock would be restored, but there is no provision in the Farm Credit Act as to the restoration of any losses charged against allocated surplus. Conceivably, the amount payable on at least the allocated surplus portion of the patronage dividends some years hence might be less than when the patronage dividends were issued. If this possibility were considered to preclude a bank for cooperatives from meeting the additional 15-year requirement of section 531, although a reasonable interpretation could be otherwise, it would mean that none of its patronage dividends, except those paid in money, could qualify for deduction.

These provisions would give the banks for cooperatives two poor alternatives. Either they would have to accept a weakened financial structure and, thus, a curtailment of their ability to serve agriculture, or accept tax burdens that were not contemplated in 1955 when Congress, in effect, asked cooperatives to take over the ownership of the banks by providing a plan under which cooperatives would invest their funds in the capital of the banks in order to retire the Government stock.

Lending operations of the banks for cooperatives

The banks for cooperatives provide seasonal and term loans to about 3,000 of the nation's 8,100 farmers' marketing, supply, and business service cooperatives. Such loans constitute about 60 percent of all borrowed funds by these organizations. At June 30, 1969, the banks had loans outstanding of $1.6 billion of which $650 million were seasonal loans, generally due within one year, and $945 million were term loans maturing in from one year to about 15 years. Since the banks began operations in 1933, loans totaling $22 billion have been made. The banks extend credit on a sound business basis and they counsel with borrowers on developing sound financial structures and operating programs. Encouragement to farmers to build cooperatives through which they can improve the profitability of their farm operations has been restated on many occasions as an intent of Congress.

The proposed requirements for the method of payment of patronage dividends unquestionably will weaken the financial structures of many cooperatives, particularly those that are smaller and newer. It will become more difficult for them to even maintain their present capital structure when, in many cases, they are in dire need to build additional capital. Consequently, many of the loans could develop into serious weaknesses and possibly result in losses, thus adversely affecting the operations and financial condition of the banks for cooperatives.

Effect of section 531 on cooperative borrowers

The cooperative approach has been effectively utilized by farmers to improve the profitability of their farm operations which have historically been and are yet typically small, independent enterprises with extremely

limited bargaining power in the marketing of their products and purchase of production supplies and services. By associating together in cooperatives, farmers have created organizations which they control as member-owners and from which they benefit as patrons. The borrowing capacity justifying the credit required to make these cooperatives effective has largely been created by the implicit and explicit commitments of their members to reinvest portions of their allocations on an equity basis, as distinguished from a debt basis as section 531 would require. Term loans can be made on a sound basis by a lender only if he is reasonably assured that earnings, or in the case of cooperatives, savings or per-unit retains, will be generated in the future and that some portion of these inputs or savings will be capitalized and retained in the business as risk capital, thus creating repayment capacity. The result to be expected if section 531 is enacted is that some term loans will not be made that otherwise would have been made, such loans may be smaller and not fully responsive to the financial requirement, amortized installments no doubt will be larger than practical and maturity periods will be shorter than otherwise. These restrictions in the extension of credit will obviously be harmful to most cooperatives and to the farmers they serve and to the communities in which they operate.

Most cooperatives have some type of capitalization plan which provides for the replacement of savings or retains capitalized in prior years with current margins or per-unit retains. The objective and effect of each of these plans is to place the burden of capitalizing the cooperative on those current patrons who are benefiting from the operations of the cooperative in direct proportion to their utilization of the cooperative. The length of time for which capitalized savings must be retained in the cooperative is dependent on many factors including the capacity of the cooperative to generate net margins, whether or not new investments in facilities and equipment are being made, and the extent to which the cooperative can and desires to utilize leverage on its member-owned capital. The critical element in the capitalization programs of all cooperatives is that the retention and retirement of retained net margins is entirely at the discretion of the board of directors and, ultimately, the membership to which it is directly accountable.

The prime effect of this section of the bill is to deny to cooperatives and their members the right to capitalize earnings allocated to members which are retained in the cooperatives. The capitalization programs of the vast majority of cooperatives are based on the right and willingness of cooperative members to reinvest in equity form portions of the earnings of their cooperatives which have been allocated to them. Enactment of these provisions of section 531 would seriously jeopardize the continued financial stability, borrowing capacity, and effectiveness of many cooperatives in improving the profitability of their members' farming operations. This judgment is based on our conclusions regarding the implications of the above-mentioned prime effect of these provisions as illustrated by the following brief examples.

Table 1 compares the financial condition of a cooperative at the end of 15 years on the basis of present laws and on the basis of the provisions of section 531. This comparison shows that the financial condition has changed substantially for the cooperative operating under section 531 and that any requests by it for term loans at that point must be given considerable analysis, and if made, must be on a much more conservative basis than to the other cooperative. This is true because the risk to the lender is greater, there being no net worth to protect the lender.

Table 1. Comparison of Change in Financial Condition, 15 Years of Operations Under Section 531 and Present Law

Balance sheets	Present	15 years later	
		Under section 531	Under present law
Total assets	$500,000	$500,000	$500,000
Current liabilities	$100,000	$100,000	$100,000
Term liabilities:			
Outside borrowings	100,000	100,000	100,000
15-year member investments	-	300,000	-
Total liabilities *	$200,000	$300,000	$200,000
Net worth	300,000	-	300,000
Total liabilities and net worth	$500,000	$500,000	$500,000

Assumptions:
1. Net earnings of $25,000 annually.
2. Cash payment of 20 percent of savings each year ($5,000).
3. Remaining $20,000 each year retained as capital and a like amount of a prior issue of member capital retired in cash.

Note: The total cash payments in items 2 and 3 would fulfill the 50 percent cash requirement of section 531.

Table 2 compares the financial condition 5 years later after experiencing a period of reduced savings from that of the previous 15 years. During the 5-year period, the cooperative operating under section 531 would need to retire $100,000 of 15-year member investment ($20,000 per year was retained in each of the first 15 years), but savings available for retention would total only $20,000. The deficit of $80,000 in capital funds is shown as being borrowed on a term basis. Although this period of reduced savings has seriously affected the financial condition of the cooperative operating under section 531, if it were operating under present tax laws it would

remain financially sound with its borrowing capacity and ability to render service to its members unimpaired. This is because the board of directors has limited the retirement of equities retained in prior years to the amount of funds available from savings. This has necessarily increased the revolving cycle of equities to more than 15 years but this flexibility is essential if cooperative members are to assume the ownership risks of their own cooperative ventures thus creating the borrowing capacity their cooperatives require to be effective.

Table 2. Comparison of Financial Condition Following Five Years of Unfavorable Operations Under Section 531 and Present Law (Based on figures shown in Table 1)

Balance sheets	Under section 531	Under present law
Total assets	$500,000	$500,000
Current liabilities	$100,000	$100,000
Term liabilities:		
Outside borrowings	180,000	100,000
15-year member investments	220,000	-
Total liabilities	$500,000	$200,000
Net worth	-	300,000
Total liabilities and net worth	$500,000	$500,000

Assumptions:
1. Net earnings of $5,000 annually.
2. Cash payment equal to 20 percent of earnings each year($1,000).
3. Cooperative under present law uses excess cash ($4,000 per year) to retire old equities to maintain net worth at $300,000.
4. Cooperative operating under section 531 retains $4,000 per year but must retire $20,000 per year of 15-year investments.

Note: The total cash payments in items 2 and 4 would fulfill the 50 percent cash requirement of section 531.

Enactment of section 531 would, as shown in Table 1, transform the character of the member investment in most cooperatives from owners' equity to debt. The most salient and injurious implication of this result is that the term borrowing capacity of cooperatives would be greatly reduced if not destroyed by their inability to financially withstand periods of unfavorable operating results as demonstrated in Table 2.

A bank for cooperatives or any other lender contemplating a term loan to a cooperative operating under section 531 cannot avoid giving prime consideration to two unfavorable facts: (1) The cooperative is faced with annual obligatory retirements of member investments pursuant to section 531 which are equal to 80 percent of its average long-term annual savings and substantially greater than its recent capacity to generate savings; and (2) no repayment can be anticipated unless and until net savings exceed the long-term average or as it may become possible for the cooperative to achieve its long-term average net saving with a lower asset investment. Obviously, the term lender would be forced to tailor his lending policies regarding loans to cooperatives in recognition of the fact that as long as a term loan is outstanding to a cooperative operating under the provisions of section 531, he must be prepared to realize on security in satisfaction of the loan. The potential for rapid deterioration of the financial condition of the cooperative and his position would be continual and, to a great extent, beyond his control or that of the organization's board of directors allowing, at best, a restricted grace period during which necessary adjustments to operations can be identified and effected.

The inescapable conclusion is that the enactment of section 531 would do serious harm to most cooperatives and might actually destroy a number of them. While the purpose of section 531 appears on the surface to assure cooperative members of receiving their allocations in cash within a stated period of time, it would in actuality deprive many cooperative members of the organizations which they have been encouraged by Congress to build in their own interest. Additionally, the enactment of this section of the House bill would effectively preclude farmers from acting together in the future to alleviate their income problems on their own initiative.

Inasmuch as section 531 would not increase tax revenues, but would impair the capacity of farmers through their cooperatives to provide, and obtain financing for, marketing, purchasing, and farm business services for themselves, the Federal Farm Credit Board and the banks for cooperatives consider it to be in the public interest that section 531 should be deleted from the tax reform bill.

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The COOPERATIVE LEAGUE of the USA

a national federation of cooperatives

Stanley Dreyer, president

SUMMARY OF TESTIMONY OF THE COOPERATIVE LEAGUE OF THE USA

- - - Recommends deletion of Section 531 of H.R. 13270.

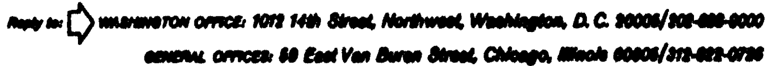
- - - Points out that this section is discriminatory to cooperatives.

- - - That no hearings on this provision were held to permit cooperatives to explain their opposition.

- - - That cooperatives would be handicapped severely in raising development capital.

- - - That this legislation preempts a proper function of the cooperative's board of directors.

- - - That it would place a roadblock in front of cooperative development at a time when government policy is to encourage cooperatives as a means of shoring up farm income and assisting those in urban poverty to escape by means of cooperative enterprises.


WASHINGTON OFFICE: 1012 14th Street, Northwest, Washington, D.C. 20005
GENERAL OFFICES: 59 East Van Buren Street, Chicago, Illinois 60605

TESTIMONY OF THE COOPERATIVE LEAGUE OF THE USA
TO THE FINANCE COMMITTEE OF THE U.S. SENATE
ON THE TAX REFORM ACT OF 1969 (H.R. 13270)

BY JERRY VOORHIS, PAST PRESIDENT OF THE LEAGUE

September 22, 1969

The Tax Reform Bill, as it passed the House of Representatives, contains provisions affecting cooperatives which are ill conceived, discriminatory, extremely damaging to American farmers, and which, if finally enacted into law would be punitive in nature.

One such provision would require after a short period of years that cooperatives must pay out fifty per cent of their patronage refund in cash. Another would require that capital investment of cooperative members be returned to them in cash within 15 years. These provisions were inserted in the Tax Reform Bill without any notice whatsoever having been given to cooperative organizations or businesses. They were inserted after the Committee on Ways and Means had, however, heard testimony from professional opponents of cooperative business enterprises. I shall not in this statement undertake to expand on the obvious unfairness of this procedure. For it is plain to see. I will only express deep appreciation to this distinguished Committee of the United States Senate for inviting testimony from Cooperatives on this vitally important subject.

Neither shall I dwell at any length upon the values and contributions to the health of our national life and economy which cooperative institutions have made and are making today. I shall only point out that agricultural cooperatives are the one best hope, if not the only substantial hope, which the independent owner-operated farmers of this country have to survive in an economy dominated by huge monopolies, some of which are attempting

at this very moment to invade the field of agriculture and drive the independent farmer out of business. Concerning cooperatives in general, it may be pointed out that they are a legitimate and unique form of voluntary enterprise which make it possible for millions of people, including even very poor ones, to participate as owners of their own businesses in our American economic life. Something like a quarter of our American families are owners of businesses today only because the cooperative form of business enterprise opens that door to them.

Surely this is something that Congress does not want to destroy. In fact the Government of the U.S. is right now urging the formation of cooperatives by low-income people as one of the most constructive ways of enabling them to work their way out of poverty. The critical problem is how to secure enough capital to make such cooperatives viable institutions. Every encouragement should be given to these cooperatives to accumulate capital. And it need hardly be pointed out that investors aren't going to rush to provide it. It must be supplied basically by the members.

But if Section 531 were to be permitted to remain in the Tax Reform Bill a fatal blow would be struck at the hope of cooperatives of low-income people to accumulate the modest capital which they must have.

The provisions in the pending legislation would not raise a single cent of additional revenue. The Revenue Act of 1962 which was well and thoughtfully hammered out by the Congress makes absolutely certain that both cooperatives and their patrons will pay their full share of taxation. Indeed that Act already requires that twenty per cent of all patronage refunds be paid in cash to members and contains requirements of the strictest character which require cooperatives to obtain from their members their consent to receive a portion of their patronage refunds in stock or certificates of investment before the

cooperative is allowed to treat those payments as "qualified patronage refunds." While this provision laid very onerous additional burdens upon cooperatives, it nonetheless received almost general support from cooperative organizations, and I am confident that practically every member of Congress believed when that Act was passed that the question of taxation of cooperatives had been well and thoroughly settled for a long time to come.

I feel, therefore, Mr. Chairman, that cooperatives in this country are entitled to regard as ill timed, ill conceived, and a breach of faith the inclusion of this discriminatory provision in the pending legislation.

Congress does not presume to tell the other segments of the business community how they must dispose of their dividend payments or their patronage refund rebates if they make any. Why, then, should cooperatives be singled out in this manner? It is important to bear in mind that cooperatives cannot, in the nature of the case, raise capital in the same manner that other businesses do. The shares and securities of cooperatives never rise above par, are not, therefore, in any way objects of investment for the average investor, and are of real value only to those who need and use their services.

Patronage refunds paid in non-cash form constitute the member-patron's contribution to the capital of his cooperative. The nature of that as a capital subscription cannot be blurred without seriously damaging the opportunity of cooperatives to secure the financing they must have to stay in business. The 15-year pay out requirement would probably do that very kind of damage. The enemies of cooperatives know this very well indeed. That is why they have proposed it.

And again -- why should Congress place such a requirement on cooperatives when it does not propose doing the same thing with respect to their competitors? Such a provision -- across the board -- would have to provide

that all corporations retire their outstanding stock every 15 years and begin all over with their financing.

It is pertinent at this point to recall that the obligation to return as patronage refunds to patrons their proportionate share of earnings is no exclusive province of cooperatives. Any business, including the large corporations, may obligate itself if it chooses to pay back earnings to patrons in proportion to their patronage just as cooperatives do.

The pertinent fact is that other businesses do not choose to do this. Cooperatives by their very nature must so choose.

Opponents of cooperatives make it their business to misrepresent the essential differences between cooperatives and other businesses. They deliberately call patronage refunds dividends and speak of the net margins of cooperatives as profits. They speak of member-patrons and shareholders as if they were the same. They are not. They disregard the essential fact about a cooperative business.

That fact is that the cooperative is formed, owned, and controlled by the same people who patronize it and by no one else.

Hence the cooperative binds itself to operate on a non-profit basis so far as business with its members is concerned. The earnings which result from business with members legally belongs to those members, not to the cooperative. In other businesses the earnings belong to the business not certainly to its customers or patrons. Such a concept sounds ridiculous on its face.

The cooperative business must return to its members all of their share of the earnings.

On any business a cooperative does beyond this and which it is not obligated to return to members it is fully taxed at regular rates.

But the second point is that any business may if it chooses operate as cooperatives do -- provided it obligates itself ahead of time to return to its customers -- not its stockholders -- their share of profits. Other businesses want to keep their profits or to pay them in dividends to shareholders -- mostly the former.

They can do that.

Cooperatives cannot.

This is an essential basic difference and the tax laws have always recognized it. So have the courts.

It should not now be blurred by action of this Congress, hastily taken.

Neither should it penalize cooperatives nor deny them their main opportunity to gain the working capital they so badly need.

Remembering that hardly any cooperative members are in any sense wealthy people, it should be quite clear that the one best time for them to make investments in their cooperative businesses is when they receive their patronage refunds. What in practical terms it means when a portion of these patronage refunds are paid in shares or certificates of ownership is this: it means that instead of simply receiving a certain number of cash dollars, the cooperative member receives his share of a new or improved fertilizer plant, milk processing plant, cotton seed oil mill, petroleum facility, feed mill, or other facility, which will strengthen basically his economic position and enable him to stand taller in the market place.

Again, in practical effect, what the bill as it came from the House proposes to do is to tell cooperative members that they are forbidden to authorize their cooperative to invest their patronage refunds, above the 20% cash requirement, in any kind of plant that would expand or improve the

services of that cooperative to its members.

I do not believe the Senate, or indeed the House on reflection, wants to say a thing like that to American citizens. It is, however, precisely what some of the most clever opponents of cooperatives and those who would like to cripple their competitive position would indeed like to have Congress say.

For all of the foregoing reasons, it is the earnest hope of the Cooperative League of the United States and certainly of your present witness, that this distinguished Committee will in its wisdom eliminate Section 531 from this Tax Reform Bill because it is a punitive provision against cooperatives, and raises not one cent of additional revenue.

NATIONAL COUNCIL OF FARMER COOPERATIVES, 1200 SEVENTEENTH STREET, N.W., WASHINGTON D.C. 20036, TELEPHONE (202) 659-1525

S T A T E M E N T   O F

NATIONAL COUNCIL OF FARMER COOPERATIVES*

In Opposition to

Section 531 of H. R. 13270
Tax Reform Act of 1969

BEFORE THE

SENATE COMMITTEE ON FINANCE

September 22, 1969

* Presented by Melvin E. Sims, President

SUMMARY

of

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Statement of

National Council of Farmer Cooperatives

in Opposition to

Section 531 of H. R. 13270

Tax Reform Act of 1969

before the

Senate Committee on Finance

September 22, 1969

Identification

I am Melvin E. Sims, President of the National Council of Farmer Cooperatives. The Council is a national organization whose members are farmer-owned and farmer-controlled cooperative associations engaged in marketing practically every type of agricultural commodity and furnishing the major types of farm supplies to their members and patrons. Approximately 4,500 farmer cooperatives serving several million farmers are represented in the Council membership.

I myself am a farmer and reside at Liberty, Illinois. Since my return from active duty in World War II, I have in partnership with my brother operated our family farm in Adams County, Illinois. My livelihood comes from farming and I am not now and have never been a salaried employee of any of the cooperatives with which I have been affiliated.

I became interested in cooperative work when I began farming in the 1940's because I learned early that only through cooperation can farmers hope to get a fair return for their products and share equitably in the national income. I have contributed much time, effort and capital to the local, state and regional

cooperatives of which I have been a member and an officer. I have done this because I have learned through experience that self-help is the only sound and enduring basis on which farmers can hope to protect their interests in building a stronger agriculture free from government aid and domination.

In appearing before you today on behalf of the Council, I speak as one of hundreds of thousands of farmers who cannot be here in person but who are seeking daily through their own cooperative business organizations to get a fair return from their farming operations through their own efforts. I speak as one of that large group of farmers who have built their own cooperative organizations and whom the sponsors of the cooperative section of this bill profess they seek to help. I know that their proposal would do us irreparable harm.

Position

We are opposed to Section 531 of H. R. 13270 which would substantially and adversely change the present methods of financing cooperatives and we urge your Committee to delete this section in its entirety when you report the bill to the Senate. In support of our position I shall summarize what the section provides, shall discuss the background to inclusion of this section in the bill and shall explain the substantive reasons why the section should be deleted.

What Sec. 531 Provides

The present minimum 20 percent required to be paid in cash of patronage refunds of all cooperatives and non-patronage distributions of "exempt" cooperatives in order to qualify the total patronage refunds and non-patronage distributions for deduction by the cooperatives would for taxable years beginning

in calendar 1970 and for ten years thereafter be increased 3 percent annually. Thus for taxable years beginning in 1979 and thereafter the required total minimum cash payment would be 50 percent of the total patronage refunds of all cooperatives and non-patronage distributions of "exempt" cooperatives instead of the present 20 percent in order to qualify the total patronage refunds and such non-patronage distributions for deduction by the cooperatives. However, the amounts in excess of 20 percent required to be paid out in cash in future years could be paid to patrons of the current year or could be paid in redemption of past allocations.

In addition, for taxable years beginning in calendar year 1970 and thereafter (1) that part of patronage refunds of all cooperatives and non-patronage distributions of "exempt" cooperatives not paid currently in cash and (2) per-unit retain allocations, in order to be qualified and thus deductible currently by the cooperative would have to be payable in money within a 15-year period beginning with the close of the taxable year. This requirement, under the bill, could be met by appropriate By-law provisions requiring such payment or by an unconditional written evidence of indebtedness issued for the remainder not paid in cash which matures within the 15-year period.

Background to Inclusion of this Section in the Bill

The present basic tax treatment of cooperatives and their patrons was enacted by the Congress in the Revenue Act of 1962. Preceding this enactment there were public hearings on the subject before the House Ways and Means Committee on 13 hearing days in the consecutive years 1958-61 at which 1,090 pages of public testimony were presented. Thereafter, 272 pages of public testimony were pre-

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sented before your Committee on two hearing days in 1962 prior to the enactment in the Revenue Act of that year of the current tax treatment of cooperatives and their patrons.

Section 531 of the current bill comes to you from the House without one word of public testimony or without any opportunity for one word of public testimony by any representative of any cooperative in the country on the subject before the House Ways and Means Committee. Our search of the 5,690 pages of the fifteen volumes of the printed hearings before the House Ways and Means Committee on Tax Reform, 1969, discloses reference to the subject by only one witness.

That witness, Mortimer M. Caplin, of the law firm of Caplin and Drysdale, a former Commissioner of Internal Revenue when the Revenue Act of 1962 was enacted, testifying on behalf of the National Tax Equality Association on February 24, 1969, before the House Ways and Means Committee, advocated that which the National Tax Equality Association has advocated unsuccessfully for over 20 years--that the earnings generated by farmers through their cooperatives should be subjected to a double tax, first at the cooperative level and what then is left at the farmer level. This long time aim of the National Tax Equality Association was rejected clearly and we thought finally by the Congress in 1962 when it established a detailed procedure for the obtaining of a single income tax either at the cooperative or patron level on all earnings generated by the operations of the cooperative.

This plea for double taxation of cooperatives by Mr. Caplin at the House Ways and Means Committee hearings was clearly extraneous to the announced subject of the hearings. In the press release of January 29, 1969, by the Chairman of the House Ways and Means Committee, announcing the public hearings to begin on February 18, 1969, there was given a complete outline of the subject matter of

the hearings on which "Testimony will be received." Under the 17 subjects including 62 sub-subjects announced in the press release there was not one word which directly or indirectly suggested that any testimony would be received or any action would be considered on the subject of taxation of cooperatives in development of a tax reform bill this year. There was sound reason why this subject was not included and was not contemplated to be included within the scope of action by the House Ways and Means Committee in the area of tax reform.

An honest effort has been made by cooperatives and their farmer members throughout the country to comply with the spirit and the letter of the provisions of the new tax treatment of cooperatives and their patrons provided by Congress in 1962. The complaints concerning this tax treatment have been few and have come largely from the competitive business interests which want to handle a larger share of the farmers' business. There has been practically no litigation over these provisions.

Secondly, and more important, there has been no published study on a nation-wide basis by the Internal Revenue Service, the U. S. Department of Agriculture, any government agency or anyone else as to the capital structures and methods of financing of all farmer cooperatives in the country for any year or for the full six-year period since the current tax treatment of cooperatives became effective for fiscal years beginning after December 31, 1962. Congress did have full facts before it in 1962 in the form of two studies by the Farmer Cooperative Service, U. S. Department of Agriculture, "Methods of Financing Farmer Cooperatives," published as General Report No. 32 in June, 1957 and "Revolving Fund Method of Financing Farmer Cooperatives," published as General Report No. 41 in March, 1958. Your Committee and all interested parties then had recent facts as to the pertinent operations of farmer cooperatives upon which to base decisions. But they do not have any such facts today.

Suddenly, in the absence of any published or known facts on which to base an informed decision, after the executive session of the Ways and Means Committee on July 23, 1969 as it was nearing the end of its executive sessions, it was announced that the Committee had decided tentatively to increase the current required cash payment of cooperatives to members and patrons beginning in 1970 from 20 percent to 50 percent within a three year period and to require cash payment of all retained earnings in five years. After the members of the Committee heard from the grass roots as to how quickly such a requirement would liquidate most of the farmer cooperatives in the country, the Committee, six days later on July 29, in its final decision adopted the proposal which is now before you.

I shall now discuss the substantive practical reasons why this proposal should be rejected in its entirety.

Why Section 531 Should be Deleted

- 1 -

It is based on the erroneous premise that the members and patrons of a farmers' cooperative do not individually have a choice as to investment of part of their patronage refunds in the cooperative.

The Ways and Means Committee report accompanying this bill states in part as to reasons for the changes proposed by Sec. 531 that under the methods of consent by the patron to contribute part of the patronage refund to the capital of the cooperative, "the patron often does not have an independent choice between investing each patronage allocation or per-unit retain allocation in the cooperative or retaining it for his own use." The report also states that "This choice is frequently made by the members as a group, and it may govern the use of a patron's funds even though he is not a member, or became a member after the

cooperative's practices in this regard were established." These statements are not in accord with present law and practice.

Of course the members of every business enterprise adopt rules and operating procedures for the conduct of the business. Those rules and operating procedures are, as to cooperatives, adopted by their members or by the members of the Board of Directors elected by the members in accordance with the specific requirements of the governing state statutes. Those rules and operating procedures when adopted by the majority or other legally required percentage of the Board or of the members are binding upon all members and not only on those who favor their adoption. In such manner are all democratic business enterprises operated. Indeed, decisions by a majority permeate the whole fabric of our economic, political and social structure.

But with respect to the part of a patronage refund that a member or patron is required by a cooperative to invest in the capital of his association and include in his taxable income, he does have individual choice, indeed an "independent" choice. Under Sec. 1388(c) of the Internal Revenue Code, adopted by the Congress in 1962, members of cooperatives have to be furnished "a written notification and copy of such bylaw" requiring capital contributions of parts of their patronage refunds before the obligation is effective as to them. Indeed, the Income Tax Regulations (§1.1388-1 (c)(3)(ii) issued by the Internal Revenue Service for the administration of this provision in the law go a step further to insure that members and prospective members of a cooperative have an individual and fully informed choice by providing that:

> "The written notification from the cooperative organization must inform the patron that this bylaw has been adopted and of its significance. The notification and copy of the bylaw shall be

given separately to each member (or prospective member); thus, a written notice and copy of the bylaw which are published in a newspaper or posted at the cooperative's place of business are not sufficient to qualify a written notice of allocation under this subdivision." (Emphasis added)

Thus, it is up to each member or prospective member to make an individual and fully informed decision under existing law whether he will retain or obtain membership in the cooperative with the obligation for capital contribution accompanying it. If he makes the individual, independent and voluntary choice to obtain or retain membership after receiving written notice of the required capital contribution accompanying membership, he thereby consents to the investment in the capital of the association from his patronage refund income.

As to patrons of a cooperative who are not members but deal with it as nonmember patrons they have the right under Sec. 1388(c) of the Code enacted in 1962 to decide individually whether they will make a comparable contribution to the capital of the cooperative and include it in their taxable income. As to those individual nonmember patrons who do not elect to do so they incur no current tax liability with respect to the patronage refund. As to these nonmember patrons who do not thus consent the cooperative and not the patron pays the current income tax thereon.

Contrary to statements on page 168 of the House Ways and Means Committee Report on this bill, under present law the members of a cooperative "as a group" do not and cannot make the choice for a patron who is not a member between investing his patronage allocation or per-unit retain allocation, or a part thereof, in the cooperative or retaining it for his own use. The nonmember patron must give his consent individually in a written agreement and if such consent is not given the cooperative pays a current corporate tax on the patron's patronage refund, or part thereof, which is not paid in cash. (Sec. 1388(c)(2)(A) I.R.C.)

Members of a cooperative have an individual choice under existing law (Sec. 1388(c)(2)(B) I.R.C.) as to whether they want to continue membership in the cooperative and assume the obligations as well as reap the benefits of membership after they have received "a written notification and copy of [the] bylaw" advising them of the required capital contribution of all members.

Thus, the members and the members alone and the nonmember patrons of cooperatives make the individual decisions whether they remain or become members and patrons of a cooperative and whether they thus assume the obligations for capital contributions that accompany their membership and patronage.

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It is arbitrary and would be an unwarranted dictation by the federal government to the members of cooperatives as to how to finance and operate their business.

It is clear on the basis of the recorded action of the House Ways and Means Committee that the final selection of the additional mandatory minimum cash payment of 3 percent per year for 10 years until a minimum of 50 percent is reached and the final selection of 15 years as the period within which the remainder not currently paid in cash must be paid are arbitrary. We use this word thoughtfully on the basis of its dictionary meaning of "selected at random and without reason."

First, the Ways and Means Committee announced a tentative decision following an executive session on July 23, 1969 to propose an increase in the present requirement for cash payment of 10 percent per year in 3 years to reach the 50 percent figure and to propose payment of the remainder in cash in 5 years. Then 6 days later, the committee changed the period in which the increase in cash payment from 20 to 50 percent should be accomplished from 3 years to 10 years.

Likewise, in the same short period of 6 days the time within which the retained capital must be paid out was increased from 5 to 15 years.

Not one "reason" is given by the Ways and Means Committee for the selection of any of these increased percentages or periods. There is no indication that the Committee gave any consideration whatsoever as to the effect upon the operations of farmers' own business associations of such dictation to them of how much the members should contribute to the capital of their associations and when they must pay out the capital thus contributed.

The Ways and Means Committee Report states only the conclusion that:

> "Your committee believes that patrons should be given assurance of a larger share of the patronage allocations that are included in their taxable income, and that amounts retained by the cooperative which have been included in a patron's income, whether patronage allocations or per-unit retains, should be paid to him not later than 15 years after the close of the taxable year with respect to which the allocation is made or the retain certificate is issued."

In striking contrast to the absence of any known or stated "reason" for adoption of the proposed ultimate minimum 50 percent cash payment figure by the House Ways and Means Committee, the Senate Committee on Finance in 1962 had and stated a specific reason for adopting the 20 percent figure which became law and is now in the statute.

Some of you who were members of this Committee in 1962 will recall that when the Revenue Act of 1962 (H. R. 10650) came to your Committee from the House of Representatives it provided for withholding on interest, dividends and patronage dividends at the rate of 20 percent. The specific changes on this point

which were made by your Committee and later enacted into law were reported at page 112 of the Report of the Committee on Finance on H. R. 10650 (Report No. 1881, 87th Congress, 2d Session) as follows:

> "Your committee's bill has substituted for the withholding provision a reporting system for dividends, interest, and patronage dividends. However, in the case of patronage dividends, withholding also served the purpose of providing the patron with at least enough funds to pay the full first bracket tax on any qualified allocations taxable to him. Your committee believes that it would be unfortunate to require the patrons to report these qualified allocations for tax purposes without being sure that the cooperative made available to the patrons <u>enough cash to pay at least the first bracket income tax.</u> To give assurance that the cooperative provides the patron with <u>at least enough money to pay this first bracket tax,</u> your committee has provided that cooperatives must pay at least 20 percent of their patronage dividends (and in the case of tax-exempt cooperatives other income distributed on a patronage basis) in cash if the cooperatives are to receive any deductions for allocations (and the patrons are to be required to include any such amounts in their income)." (Emphasis added)

Let us look at the results of the application of the reasoning of your Committee in 1962 to the situation today. For 1968, I am informed that the first bracket income tax rate was 15.4 percent, including the surtax. Under the provisions of the bill as sent to you from the House of Representatives, I understand the effective first bracket rate would be substantially less.

Let us examine the pertinent factual situation a bit further. The average realized net farm income per farm operator in the U. S. in 1962 was $3,424.1/ For the average farm operator with such farm income in 1962 who was single and took the standard deduction, his net taxable income would have been $2,481.60 with a tax of $496.32 at an effective rate of 20 percent.

How does this compare with the current situation?

The average realized net farm income per farm operator in the U. S. in 1968 was $4,841.00.1/ For the average farm operator with such farm income in 1968 who was single and took the standard deduction, his net taxable income would have been $3,756.90 with a tax of $708.19 at an effective rate of 18.8 percent.

From 1965 to 1968, net taxable income of at least $22,000 would be required to be subject to an effective tax rate of at least 50 percent.

Hence it is unmistakably clear on the basis of these facts and the reasons stated by your Committee in 1962 for setting the minimum required cash payment at 20 percent, that there is no justification for the proposal to increase the minimum cash payment in order to qualify the patronage refunds for deduction by the cooperative.

We have been unable to learn any reasons for the selection of the 50 percent cash payment figure or the 15-year figure. There has come from some members of the House Ways and Means Committee reference to one point that might have had some influence on the action taken.

1/ Farm Income Situation, July, 1969, Table 3D, page 70
Economic Research Service, U. S. Department of Agriculture

Mention has been made of a Report issued in 1966 by the Canadian Royal Commission on Taxation which recommended in effect that the Canadian law be changed so that patronage dividends would be deductible by cooperatives in computing taxable income only to the extent that half of them had been paid in cash. We are informed that this and the other far-reaching recommendations of the Canadian Royal Commission on Taxation are recommendations and recommendations only and that many of the recommendations of this Commission are unlikely to be adopted when a bill is proposed by the Canadian Government. Aside from the fact that there is no relationship between a recommendation of a Canadian Commission and the formulation of a fair tax treatment for cooperatives and their farmer members in the United States, it is significant that even this Commission in Canada has not recommended any time limit on the retirement of cooperatives' membership capital as is now proposed in Sec. 531 of the bill before you.

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The proposed requirement that cooperative corporations retire the capital contributed by members and patrons within 15 years or any other specific period of time is discriminatory and punitive in that no such requirement is made of other corporations, partnerships or other business enterprises.

It is quite clear that the capital invested in non-cooperative corporations or other business enterprises is subject to no regulatory or other requirement by the federal government that it be retired at any particular time or within any specified period as is now proposed for cooperatives.

The practices and policies of cooperatives vary widely in their capitalization plans as determined by their members on the basis of their individual needs. In some cooperatives there is a continuing need for new and improved

facilities to efficiently serve the marketing and purchasing needs of their members. Cooperatives cannot find outside of their members and other patrons adequate sources for providing the capital to meet these needs. Hence farmers know and are willing out of the earnings of their cooperatives to contribute this needed capital to furnish the base on which to finance the needed facilities. They do this in many cases with the intent to provide a permanent or long-term capital base and with no expectation that their capital investment will be retired at any specific time in the future.

By thus singling out cooperatives in compelling retirement of equity capital by arbitrary federal edict, the 15 year retirement requirement would greatly restrict or cause abandonment of beneficial services historically provided by cooperatives to farmer patrons which benefit not only themselves but consumers and the entire public.

The historical method by which farmers have generated the needed capital to finance their cooperatives is from their operations. Sale or issuance of securities to the investing public has not been feasible or practicable for cooperatives. Limited permissible returns on investment in cooperatives, the fixed value of the securities and the seasonal hazards of farming operations have had no appeal to growth minded investors. Hence farmers have found that the only sound and practical way to finance their off-the-farm businesses is to reinvest monies otherwise payable to them from their self-help business enterprises to provide the capital required for facilities, operations and as a basis for credit.

Some of the larger, older and stronger cooperatives could perhaps survive with a 15 year requirement for retirement of their membership equity capital. Many however would suffer a continuing strangulation, become ineffective and finally collapse.

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While Section 531 is not estimated to yield any revenue gain or loss to the federal government, it will actually result in the loss of revenue

Under many sections of H. R. 13270, the Report of the Ways and Means Committee gives the "Revenue Effect", estimating the revenue gain or loss which would result from the adoption and application of the proposed changes. The report is entirely silent as to any "Revenue Effect" estimated to result from the adoption of the proposed changes pertaining to "Cooperatives."

In theory, and in theory only, it is estimated that these proposed changes would not have any significant effect on tax revenue. This is because the imposition of a requirement for a larger current cash payment and of a specified time for retirement of the equity capital would not change the amount of the current or ultimate tax liability thereon.

However, in actual practice it is inevitable that the damage that would be done to the operations of cooperatives through the undermining of their capital structures would gradually retard and impede their operations with decreasing earnings subject to tax either to the cooperative or its members and patrons. This is the practical and predictable consequence of the application of the proposed new rules. While some of the larger and older cooperatives might be able to weather the storm, at least for awhile, the ones which would suffer the most are those operating at the local level serving the small and medium size family farmers who need their services most. Many of these would gradually disappear and be liquidated through the undermining of their capital structures.

In at least one area, the proposed requirement that membership capital be changed from equity to debt would definitely cause the loss of some tax revenue

to the government. In some instances non-exempt cooperatives pay limited dividends on the stock or other certificates issued to evidence invested patronage refunds by members and patrons. These dividends are paid out of net earnings after payment of taxes. Through the conversion of these investments from equity capital to debts by the proposal in Section 531, the payments thereon would be interest and deductible in determining the net taxable income of the cooperative. Hence the taxes payable by the cooperative in such cases would be correspondingly reduced.

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The required conversion under Section 531 of membership capital from equity to debt would seriously and immediately impair and ultimately destroy the borrowing ability of cooperatives to soundly finance growing farmer demand for services and facilities

There are several sources from which farmer cooperatives borrow capital to finance their operations. While some cooperatives can obtain limited financing through commercial banks and other sources the major source of credit is the Banks for Cooperatives of the Farm Credit Administration which were established in 1933 to provide a specialized credit service to farmers' marketing, supply and service cooperatives.

There are no recent statistics on the amount of total borrowed capital by the farmer cooperatives in the United States from sources other than the Banks for Cooperatives. The latest study by the Farmer Cooperative Service of the United States Department of Agriculture indicated that almost 58 percent of the outstanding borrowed capital of farmer cooperatives was supplied by the Banks for Cooperatives.

According to the latest information from the Farm Credit Administration, the Banks for Cooperatives had loans outstanding as of June 30, 1969, in the aggregate amount of $1,594,400,000 to 2,955 cooperative associations. Of this total, $649,200,000 (40.7%) was in "Seasonal" loans and $945,200,000 (59.3%) in "Term" loans. The number of cooperative associations with term loans outstanding as of June 30, 1969 was 2,705 or 91.5% of the borrowing associations. Although a specific breakdown on the maturity periods of these outstanding loans is not available we understand from officials of the Farm Credit Administration that in some instances the maturities run up to 20 years, the range on the majority of these loans is from 4 to 12 years, a significant number mature within 12 to 15 years and a relatively small number mature within 15 to 20 years.

The latest information on the financial structure of the farmer cooperatives of the country is included in a study by the Farmer Cooperative Service of the U. S. Department of Agriculture for the year 1962 which is expected to be published in the near future. Although this is not current information and it does not reflect the situation for a year after the new tax treatment for cooperatives and their patrons became effective in 1963, it is the most recent information which we have been able to obtain on a nation-wide basis. Pertinent information resulting from that study is as follows:

Total No. of Associations		8,522
Assets		$5,322,000,000
Liabilities and equity capital		
Equity capital	- $3,215,000,000 (60.4%)	
Borrowed capital	- 1,032,000,000 (19.4%)	
Other liabilities	- 1,075,000,000 (20.2%)	5,322,000,000

What do these figures show? They disclose the inescapable fact that the capital structure of farmer cooperatives would be immediately impaired and undermined and gradually destroyed through the imposition of a 15 year requirement for the retirement of their equity capital.

If the proposal for a due date within 15 years or any other fixed time on all membership capital should become effective, members' investments would cease to be equity and instead become debt capital. As the past investments of members in the equity capital of their associations are retired and with no new investments by current members in the equity capital, there would necessarily be a continued shrinkage and ultimate disappearance of their net worth. Obviously the sources of credit for financing their operations would gradually disappear.

The real victims of this arbitrary and discriminatory action by federal edict would not be the cooperative corporations but the farmers themselves who have built and are building these self-help business enterprises and would then be denied the services and facilities they have joined together to provide through their own investments and patronage.

It is beyond our comprehension that any committee of the Congress or any Administration would single out this one type of business - cooperatives - and dictate to their farmer members when their investments from their own tax paid dollars must be retired from the business. Certainly the federal government has not attempted to so regulate the investments of partners in partnerships or the investment of stockholders in their proprietary corporations. The 15-year proposal in no respect can be classified as a revenue measure or tax reform. It can properly be classed only as a regulatory measure which would bring about the ultimate destruction of farmers' self-help cooperative business enterprises and reverse the declared policy of Congress which states:

"It is declared to be the policy of Congress to promote

the effective merchandising of agricultural commodities in interstate and foreign commerce so that the industry of agriculture will be placed on a basis of economic equality with other industries, and to that end protect, control and stabilize the currents of interstate and foreign commerce in the marketing of agricultural commodities and their food products --

. . . .

. . . .

(3) by encouraging the organization of producers into effective associations or corporations _under their own control for greater unity of effort_ in marketing and by promoting _the establishment and financing of the farm marketing system of producer-owned and producer-controlled cooperative associations and other agencies._" 12 U.S.C. 1141(a)(3) (Emphasis added)

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Section 531 would produce grave and costly enforcement problems for the government and compliance problems for farmer cooperatives

The Secretary of the Treasury in his testimony before your Committee on September 4, 1969, stated that "The additional 30 percent requirement is complex and creates serious administrative problems." He recommended "that the additional 30 percent pay-out rule be eliminated."

With this recognition on the part of the Treasury Department which would be responsible for administering such provision, we believe no more need be

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said to establish the complete lack of justification for such provision on the basis alone of the administrative problems that would be encountered in an attempt to administer it. Administration and compliance under present law is relatively simple compared to what it would be under the new proposals. We ask the members of your Committee to try to visualize the utter chaos and exorbitant expense in government auditing procedures and cooperative bookkeeping in attempts to respectively audit and maintain records on cash patronage refund payments <u>which vary percentage-wise each year over a ten-year period</u> and which might under the proposal be used <u>either as payments to current patrons or in retirement of allocations of past years.</u> It can properly be asked "For what purpose would this exercise in extravagance and futility be undertaken?" In many cases, the costs in record keeping would far exceed the amounts of the patronage refunds involved. This would be particularly true in the cases of cooperatives operating over a wide area with thousands of small farmers receiving patronage refunds in comparatively small amounts.

It is regrettable that the Secretary of the Treasury in his appearance before your Committee on September 4 did not point out the complex and serious problems that would be imposed on cooperatives by adoption of the 15-year cash payment rule and recommend that it too be eliminated. Let me point out just one example of the divisive effects upon many cooperatives that would be certain to result from the application of just one provision in Section 531 for implementing the 15-year rule.

Section 531 provides as one way to implement the 15-year rule, as follows:

> "at all times on and after the date of issuance of such written notice of allocation, the bylaws of the organization require the remainder of such patronage dividend, or such payment, to be paid in money within the 15-year period

beginning with the close of the taxable year with respect to which such written notice of allocation is made, and the bylaws provide that such requirement shall in no event be changed without the consent of those adversely affected, . . ." (emphasis supplied)

What do the underlined words mean and how would the Internal Revenue Service interpret them if such provision should be enacted into law? Let's take the case of Cooperative A with 1,000 members. These 1,000 members receive for fiscal year 1970 patronage refund allocations averaging $80 each amounting to a total of $80,000. The By-Laws of Cooperative A contain the provisions in Section 531 of the bill as quoted above. The By-Laws also provide that amendments thereto may be made by the affirmative vote of 75 percent of the members present at a meeting at which a quorum is present. In 1985, there is a severe drought, Cooperative A operates at a loss and is unable to retire the patronage refund allocations issued for fiscal 1970. A membership meeting is duly called. 800 members are present. 90 percent of the members present consent to extend the time for retirement of the 1970 patronage refund allocations and 10 percent of the members present do not consent. What happens then? What happens when the Board of Directors of a proprietary corporation votes not to declare a dividend to the stockholders by a vote of 90 percent because there have not been earnings from which to pay a dividend? What happens when 90 percent of the members of the Senate vote for a bill and 10 percent vote against it?

The answer is obvious. All the members of a legally constituted body are bound by the decisions of the majority or other legally prescribed percentage. But Section 531 would as to cooperatives by federal law repudiate decisions by a majority in their application to a minority who do not consent.

This 15-year proposal in Section 531 when analysed in its practical application would represent a flagrant abuse of federal power and unprecedented interference with private business. It would tend to divide rather than encourage farmers to cooperate to help themselves. At this period in our national life when so much is being done materially by the federal government to assist disadvantaged groups in our nation, it is beyond comprehension that the Congress would spend any time in even considering a proposal which could only add handicaps, burdens and problems for farmers who are trying to help themselves through their own efforts.

Conclusion

I appreciate the opportunity that has been given for me to present this statement on behalf of the Council.

For the reasons documented in the statement, we respectfully urge your Committee to eliminate Section 531 in its entirety from H. R. 13270. We also respectfully urge that the conferees from your Committee maintain this position without compromise when the bill may be considered and action taken in conference.

We recognize that there is a general disposition to seek compromise when controversial issues are at stake. We sincerely believe that there is no justification for any compromise with respect to Section 531 solely on the basis of the fact of no public hearings on this issue before the House Ways and Means Committee and no adequate time now for thorough analysis in public hearings before your Committee of any compromise which may be suggested.

The operations of many farmer cooperatives today are being disrupted because of difficulties in the interpretation of hastily drawn provisions inserted by the Senate in the Revenue Act of 1926 to amend what is now Section 521 of the Internal Revenue Code, authorizing specific deductions for farmer cooperatives which meet

certain stringent requirements in that section. Since February, 1965 - over 4 years ago - the Council has been trying to get the National Office of the Internal Revenue Service to publish an official interpretation of certain provisions of that section for compliance purposes. About five years ago Internal Revenue agents in their auditing functions began placing interpretations on certain provisions in that section different from the interpretations that had been followed since 1926. To date we have no answer from the Service because of differences in the National Office between the attorneys and administrative officials as to what the provisions in question were intended by Congress to mean. We urge your Committee in the interest of sound legislation and its subsequent proper interpretation not to compound the problems for government and farmer cooperatives that now exist through further hastily drawn legislation which characterizes Section 531 as referred to you from the House of Representatives.

There are defects and problems inherent in Section 531 in addition to those already covered in this statement. An appendix to this statement describes some of these defects and problems as additional evidence why Section 531 should be entirely striken from H. R. 13270. The appendix also gives factual information concerning certain opinions which have been rendered concerning the so-called constitutional question involved in the tax treatment of cooperatives and their patrons.

APPENDIX

A. Section 531 would undermine the "Capital Fund Method of Financing" which has been adopted by an increasing number of cooperatives with approval of the Internal Revenue Service. . . . . page 1

B. Section 531 would impose hardships and inequities on the members and patrons of many cooperatives through the proposed limitation of the application of cash payments in excess of 20 percent to retirement of "any qualified written notice of allocation". . . . . page 3

C. Opinion on the Constitutional Question . . . . page 4

APPENDIX

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Section 531 would undermine the "Capital Fund Method of Financing" which has been adopted by an increasing number of cooperatives with approval of the Internal Revenue Service.

It has already been pointed out to members of the Senate Finance Committee that the provisions of the Tax Reform Act of 1969 adopted by the House of Representatives includes a section relating to taxation of cooperatives which was adopted without sufficient consideration of the impact of this proposal on government revenues or on operations of cooperatives. There is, however, one specific method of financing of cooperatives which was apparently not taken into consideration in any way by the House Ways and Means Committee at the time Section 531 of the bill was adopted. This is the "Capital Fund Method of Financing." We feel that exploration of the unanswered questions which are raised in connection with the capital fund approach by Section 531 of the bill will further demonstrate that the portion dealing with cooperative taxation should be removed from the bill by the Senate Finance Committee.

DESCRIPTION OF "CAPITAL FUND" APPROACH

A basic precept in a farmers' cooperative is that equity capital should be provided by the grower-members. The capital fund approach is deemed by many cooperatives to be the fairest and most equitable way to determine what share of capital needs should be borne by each of the grower-members. Under this plan, a grower's capital contributions are directly related to his use of the cooperative facilities.

The plan essentially works like this. A period of time is established for measurement of total crop deliveries by the cooperative's grower-members. This time period consists of a sufficient number of years to equalize the impact of varying external factors affecting crop deliveries, such as unusual weather conditions, pest damage, etc.

After each delivery season, a tabulation is made of total crop deliveries for the entire period, customarily dropping off amounts delivered in the oldest outstanding year of the period of measurement and adding deliveries for the current year. Then a calculation is made for each grower-member of his proportion of deliveries during this time period. Also, during each accounting period, the capital needs of the cooperative are determined. Each member is then responsible for a portion of the capital needs which is in direct ratio to his proportion of deliveries of product to the cooperative.

This is then translated into a dollar amount for each grower-member. If an individual's prior capital fund contributions equal his newly calculated requirements, there will be no retain or assessment for capital purposes and he will receive 100% of his proceeds in cash. However, because of the pattern of crop deliveries from year to year, it is likely there will be adjustments in each individual grower's account every year. For example, if in a particular year a grower has delivered a larger proportion of the total crop received by the cooperative than he has in prior years, his share of the capital needs (assuming

a static capital structure) will tend to increase. Thus on a per-unit basis of calculation he will be assessed or will have withheld a dollar amount to bring him up to his equitable share of the capital needs. Conversely, if he has used the cooperative's facilities to a lesser extent, it will tend to reduce the amount of capital established as his proportionate share and he will be refunded the amount which represents an excess over his established level of capital contribution.

In the event a member withdraws from the organization or ceases to produce the crop handled by the cooperative he will have received his entire capital contribution at the end of the period used by the cooperative to calculate the individual's capital contributions. Thus, if the period of measurement of deliveries is six years, at the end of that time the individual grower who is no longer delivering to the cooperative will have received full repayment for capital contributions earlier made.

The basic question which is raised in conjunction with the Tax Reform Act of 1969 is how the 15-year limitation period involved in Section 531 of the bill affects this capital fund operation, particularly in the case of a new member or one who continues to use the cooperative facilities.

FULL DISCLOSURE AND APPROVAL BY INTERNAL REVENUE SERVICE

Prior to adopting the capital fund method of financing, the cooperatives which have gone to this approach have obtained rulings from the Internal Revenue Service. In all instances the rulings have indicated full approval of this approach. They further have indicated that there are no taxable consequences to the cooperative at the time of creation of Capital Fund credits so long as any amounts retained or assessed against the individual member are fully disclosed to him and the member includes these amounts in his income at the time the credits are created.

APPLICABILITY OF PROPOSAL TO CAPITAL FUND CREDITS

At the time of creation, then, the full tax is paid on these credits in accordance with existing provisions of the Internal Revenue Code and regulations issued thereunder. It should further be pointed out that a member who has withdrawn or ceased to deliver products to the cooperative will receive repayment of his capital contributions within the period of time established for measurement of the percentage of use of the cooperative's facilities by each individual grower-member.

A question which is totally unanswered and apparently received no consideration whatsoever from the House Ways and Means Committee is how the 15-year period for repayment of per-unit retains will apply to a cooperative whose members have adopted the capital fund approach. Perhaps an illustration will be helpful.

Let us assume a member of a cooperative who has capital credits standing in his name in the amount of $2,000 as of the year 1970. As a result of the pattern of his crop deliveries and calculation of his equitable share of capital needs in 1971, he must contribute an additional $100 in capital. In 1972, again because of the factors noted above, his calculated share of capital contribution decreases by $100 and this amount is repaid to him in cash. Now let us assume a

very hypothetical situation, namely that for the next 13 years no adjustments are required in his capital fund. Then in 1986, 15 years after creation of the credit in 1971, must the cooperative redeem the $100 which was created in 1971? Does the adjustment that was made in 1972 qualify as such a redemption? If the cooperative does not redeem the 1971 credit in 1986, what are the tax consequences to the member and the cooperative? Do we get a different result depending upon whether the capital fund credit is created as a result of a per-unit retain or as a retain from a patronage dividend or by assessment?

CONCLUSION

It is obvious that the House Ways and Means Committee gave no consideration at all to the complex problems and disruptive results that would flow from the application of a 15-year limitation period (or any other limitation period) on the capital fund method of financing which has been adopted and is now in operation with the approval of members of an increasing number of cooperatives.

This is an additional compelling reason why Section 531 should be deleted in its entirety by the Senate Finance Committee and no action be taken to change the present tax treatment of cooperatives unless and until there has been an adequate opportunity to consider the full impact of any changes proposed.

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Section 531 would impose hardships and inequities on the members and patrons of many cooperatives through the proposed limitation of the application of cash payments in excess of 20 percent to retirement of "any qualified written notice of allocation."

Section 531 would amend Section 1388(c)(1) of the Internal Revenue Code to provide in part that the additional three percent required to be paid in cash each year for ten years beginning in 1970, until an additional 30 percent is paid in cash in 1979 and subsequent years, is paid either:

> "(i) as a part of such patronage dividend, or such payment,
>
> (ii) or in redemption (to the extent allocated by the payor to such patronage dividend for the purpose of meeting the requirements of this clause, if not previously allocated to any other patronage dividend) of any qualified written notice of allocation previously paid as a part of a patronage dividend, or such payment, for any taxable year, and. . ."(Emphasis added)

The term "qualified written notice of allocation" was first introduced in the Internal Revenue Code in Subchapter T enacted by the Congress in the Revenue Act of 1962 to provide a new tax treatment of cooperatives and their patrons. Hence, "qualified written notices of allocation" exist to evidence the patronage refund investments of members and patrons in their cooperatives only for fiscal years of cooperatives beginning after December 31, 1962.

Many cooperatives have adopted systematic plans for redeeming or revolving their equity capital and these plans in large part provide for such retirement in the order of the years in which the equity capital was invested.

Application of the underlined provision in Section 531, quoted above, would mean that the current cash payments in 1970 and thereafter used in retirement of past patronage refund investments would have to be applied in retirement of such investments made for 1963 and thereafter even though some pre - 1963 investments had not been retired.

The inequities that would thus be imposed as to the members and patrons of the pre - 1963 years compared to the treatment of the members and patrons in 1963 and thereafter are clear and could not, we believe, be intended or justified. This is another glaring example of the defects inherent in Section 531 and a further specific reason why Section 531 should be deleted from the bill.

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Opinions on the Constitutional Question

When Mortimer M. Caplin testified before your Committee on September 19, 1969, on behalf of the National Tax Equality Association, permission was given at the request of a member of your Committee for the inclusion in the record of the hearings of two opinions related to the taxation of cooperatives.

Although these opinions appear to have no pertinency to the policy question before your Committee, we deem it important that the members of your Committee have factual information as to the identity of those opinions and their basic conclusions. It is also important that your Committee be informed of another opinion that has been rendered on the same subject and its basic conclusion.

I

"The Power of Congress to Tax Cooperatives on Net Margins"

Prepared by the Staffs of the Treasury and the Joint Committee on Internal Revenue Taxation - April, 1951

This staff report prepared over 18 years ago was first released by the House Ways and Means Committee for publication in 1960.

The basic conclusion of the staff opinion implicit in its title is that Congress does have the power under the Constitution to tax cooperatives on net margins.

Two significant statements in that opinion supplementing the basic conclusion are as follows:

"Congress has an equally broad power to determine, on practical grounds to whom income should be taxed."

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> "This shows that Congress may use any reasonable standard in measuring the taxable income of a cooperative, and the mere fact that the corporation is a cooperative does not impose a constitutional restraint on Congress in the measurement of its taxable income." (Emphasis added)

II

"Taxing the Net Margins of Cooperatives: Application of Basic Tax Principles and Analysis of Constitutionality"

This is an opinion by Mortimer M. Caplin made for and published by his client, the National Tax Equality Association, on May 22, 1969. His basic conclusion to the 51-page opinion is that:

> "There can be no serious question that net margins constitute income to cooperatives under basic tax principles and that taxation of that income would violate no rule of constitutional law. Any discussion of the tax treatment of cooperatives must begin with these conclusions. Proceeding from that basis, the essential policy issue at stake - whether the income of today's large-scale cooperatives should continue to receive a special tax preference - must be subjected to careful and rigorous re-examination on its own merits." (Emphasis added)

III

"Constitutionality of Legislation Taxing to Patrons Income Equal to the Face Amount of Non-Cash Patronage Refunds Distributed to them by Cooperatives"

This opinion was prepared by Mac Asbill, Jr., a partner in the law firm of Sutherland, Asbill and Brennan, Washington, D. C., January 25, 1962 for the National Council of Farmer Cooperatives.

In his 18-page opinion Mr. Asbill reached the basic conclusion that:

> "For the reasons set forth above, legislation requiring patrons to include in income the face amount of documents evidencing their share of current patronage income of the cooperative enterprise would clearly be constitutional."

Mr. Asbill testified before your Committee on April 16, 1962, at public hearings on the Revenue Act of 1962 and his opinion is included in the part 5 of the printed hearings on that bill at pages 1709-1728. We are attaching to this statement a copy of his opinion with the request that it, too, be included in the printed record of these hearings.

What is the unanimous single conclusion drawn from these opinions? It is simply that the issue before your Committee in 1969, as in 1951 and 1962 is not a constitutional question. It is solely a matter for basic policy determination.

In 1962, after extensive hearings your Committee and the Congress decided as a basic policy matter that net earnings generated through the operations of co-operatives should be taxed to the members and patrons to the extent that their individual patronage created such net earnings. You also decided that such net earnings not distributed in cash as patronage refunds on the basis of patronage should be taxable to the members and patrons currently only where there is individual agreement on the part of such members and patrons to invest the part of the patronage refund not paid in cash in the capital of their association. We believe that after careful consideration of all the facts before you, your Committee will reach the basic policy decision that the action taken by your Committee and the Congress in 1962 is fair to farmers, their cooperatives and in the public interest and should not be changed.

STATEMENT BY THE HONORABLE FRANK CARLSON
ON BEHALF OF THE NATIONAL FEDERATION OF GRAIN COOPERATIVES
BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE
ON SECTION 531, H.R. 13270

SEPTEMBER 22, 1969

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I appreciate very much this opportunity of appearing before this distinguished Committee, on which I had the pleasure of serving for 14 years while a member of the Senate, to express the views of the members of the National Federation of Grain Cooperatives on the proposals contained in Section 531 of H.R. 13270 dealing with the tax treatment of farm cooperatives. A complex subject, I might add, which I thought had been resolved both equitably and satisfactorily by enactment into law of the Revenue Act of 1962.

Appearing with me this afternoon are the Federation's Executive Vice President, Bruce J. Hendrickson, and the organization's General Counsel, Irving Clark, who is a partner in the law firm of Doherty, Rumble & Butler of St. Paul, Minnesota. I have asked both of these men to sit with me to provide assistance with respect to any technical points which may arise since this has become an increasingly complicated subject as to details.

It was not so at one time. But I am afraid that as our farm marketing cooperatives have become more and more of an effective force in the selling and the processing for sale of grains and oilseeds for the mutual benefit of its members, opponents of this perfectly proper method of doing business have sought by a variety of extremely technical means to drive a "tax wedge" between member-patrons and the institutions they have tirelessly built and financed to further their own economic well-being. It has also been at considerable cost to these farmer-patrons,

notwithstanding allegations to the contrary by those who have ceaselessly showered the Congress year after year with "co-op tax reform" schemes designed to deprive member-owners of these institutions of the full economic benefits which both the Congress and Executive branches of our Federal System have in their wisdom seen fit to encourage over many decades in the interests of sound public policy.

As I recall the many instances in the past when I was personally involved in judgments made with respect to cooperative taxation both in this distinguished Committee and on the floor as a Senator from the great State of Kansas, the principle of the payment of a single tax upon the savings (earnings) of a farm cooperative at the investor level was never lost sight of despite the repeated attempts by opponents of these organizations to have them taxed otherwise under the guise of "reform." This has even included successive attempts to impose the "two-tier" system of levying taxes on the "profits" of these farmer-owned and controlled associations.

Despite the repeated efforts of farmers and their cooperative leaders over the years to combat this divisive tactic we have seen a successive encroachment by the government into the conduct of the business affairs of both patrons and their cooperatives as regards tax matters.

This involvement appears to be getting deeper too, judging from the proposals contained in Section 531 of H.R. 13270.

Both the proposed phased-in cash payout requirements to 50 percent by 1970 and the statutory directive to treat future contributions of capital (investments) by patrons in their cooperatives as debts of the organization are perfect illustrations of this excessive tendency by some to submerge or sink well established public policies via the taxation route.

It might be pointed out too, that neither proposal serves the interests of the government from the revenue standpoint since no additional taxes will be collected, according to estimates supplied by the Treasury Department.

Since this is to be the case, and I have no reason to disbelieve their estimates, I am at a loss to understand where any corresponding or redistribution of existing or future tax burdens (the object of tax reform) will come about as a result of the enactment of these proposals.

On the other hand, irreparable harm will be done to both farmers and their cooperatives if Section 531 is enacted into law. I can't believe that members of this Committee want to see this happen.

This is especially true in the present context of the tremendous demands being put on our limited resources budget-wise, including the U.S. Department of Agriculture. Farmers recognize this hard fact of life even in cases involving our major programs for grains like wheat. Because of this, they are attempting through various means to devise their own programs. A major effort in this direction to eventually relieve the government of its dominant role in this area is being spearheaded by cooperatives. Most certainly, any program ultimately developed will take time. But experience convinces me that the very institutions which would be destroyed by the enactment of these harsh proposals - our grain marketing cooperatives - represent the most promising vehicle for eventually effecting the transfer of grain programs to the private sector sometime in the distant future.

Now, as to the subject at hand, I well recall the days of service on this Committee prior to the enactment into law of the Revenue Act of 1962 when we exhaustively studied this subject.

At that time I remember we were very careful to erect a set of "qualifications" to insure that all noncash patronage allocations would be taxed at their stated dollar value in the hands of the patron or his cooperative would be taxed. In order to be sure that the patron had enough cash to pay the tax on these amounts we required that the cooperative include at least 20 percent of the savings in cash.

That seemed like a reasonable proposition then. It still does. I believed then and still do however, that the financial needs of these businesses is a matter which should be left more properly for them to determine by their own actions and not be impressed on them by some tax authority. This includes such jointly agreed-to decisions as those taken with respect to who is going to pay the tax on patronage distributions too, so long as the proper tax is paid by somebody.

The point which is often overlooked is the fact that these associations are voluntary as to membership. No one is under any compulsion to patronize them either, an item that those unfriendly to this form of business organization never bother to mention for self-serving reasons.

Now, it seems to me that as this Committee considers Section 531 of H.R. 13270 it ought to weigh very carefully the fatal consequences which it would have on the future ability of local grain marketing cooperatives like my own back in Kansas - the Cloud County Cooperative Elevator Association at Concordia - to provide the badly needed and growing servies which its farmer-owners demand and get right there in town.

Of equal, if not of more importance, is FAR-MAR-CO., INC., headquartered in Hutchinson, Kansas. This latter organization, a regional

grain marketing cooperative, makes it possible for members of my local to play a significant role in the key terminal and export grain markets where forces of supply and demand operate to establish prices. Markets created day in and day out by this major regional along with markets created by the other 19 regionals comprising the membership of this Federation constitute an indispensible service for the one million grain producers and 2,680 local cooperatives owning them.

Earnings derived from the activities of these regionals represent a major source of revenue for the locals. At the same time, the locals' major investments (and consequently, their member-owners) are generally those made in their regional. These are substantial too relative to others in most cases.

With limited exceptions, the capital which has been provided by farmers to build and enlarge their sphere of marketing influence has come from reinvested earnings on which farmers have willingly paid taxes on in order to supply to themselves as a group many of the services they could not economically afford to individually do. This would include such things as building and maintaining grain elevators, plants for processing their grains into more valuable products, owning rail and barge equipment, and even acquiring their own lending institution - the Banks for Cooperatives - through the systemic repayment of government capital from their own funds.

All of these have cost great sums of money, but they are providing their member-owners with an important array of services which is the way they want it.

Thus, as you study and deliberate the pros and cons of Section 531 of H.R. 13270 in the weeks and months ahead, I would urge you to ponder

very carefully whether, by enacting this proposal, you will be helping farmers or hurting them.

After it is all over, my inclination is that you will be disposed to agree with me that the wisest course is to have Section 531 stricken from the bill.

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Statement of the
NATIONAL MILK PRODUCERS FEDERATION

Before the
SENATE FINANCE COMMITTEE

H. R. 13270

Taxation of Cooperatives

September 22, 1969

Patrick B. Healy
Secretary

M. R. Garstang
General Counsel
30 F Street, N. W.
Washington, D. C.
393 - 8151

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SUMMARY

1.

The Federation

There is no conflict of interest between farmers and their agricultural cooperatives.

The Federation's statement accurately reflects the farmers viewpoint, because 75 percent of our board of directors are required to be farmers and our policy positions are adopted at meetings where farmers predominate.

2.

Farmers Control Cooperatives

The boards of directors of cooperatives are all farmers elected by farmers. Farmers set the policies of their own cooperatives by democratic process.

3.

The Farmers Freedom of Choice

Arguments to the effect that Congress must protect farmers from themselves, or from their own cooperatives, are unsound and are merely an excuse to undermine cooperatives so processors and middlemen can take greater profits at the farmers' expense.

Farmers must be permitted to operate their own organizations, financed with their own funds, in whatever manner they deem best.

Congress should not undertake to substitute its judgment in the operation of a farmers' cooperative for the sound judgment and experience of its farmer members, who have at stake not only their own capital but also their own welfare and future as dairy farmers.

Business requirements change from time to time. An inflexible across-the-board rule prescribed by Congress would be impractical.

4.

What are Cooperatives

Cooperatives are a basic form of a self-help program in which farmers acting together seek to solve their own problems, improve the quality and service of their produce, and try to obtain a more reasonable return for the labor and investment required to produce the Nation's food.

5.

Congressional Approval of Cooperatives

There is a long history in Congress of legislation to encourage farmers to improve their own position by organizing and operating their own cooperatives.

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

6.

Cooperatives Help Farmers

Cooperatives provide services for farmers when needed services are not otherwise available.

Farmers keep processing and marketing margins in line, and also the cost of farm supplies, by setting up and operating their own cooperative businesses when margins charged by others are excessive.

Cooperatives check the weights and tests of their members milk to assure fair treatment in an area which otherwise is easily subject to mistreatment.

7.

Cooperatives are Important to Consumers

Cooperatives have not sought unduly high prices. They ask only for a price level which will reflect to the farmer a fair return for his labor, taking into account the investment and risk involved.

Hourly returns for the labor of dairy farm operators, as reported by the Department of Agriculture, range from $.91 to $1.08 in the three test areas reported.

Cooperatives keep middlemen's margins under reasonable control.

Cooperatives help provide the abundant supplies of high quality food which consumers enjoy.

8.

Opposition to Cooperatives

Cooperatives meet with strong opposition because the opportunities for processors and middlemen to take large profits at the expense of the farmer is greatest when farmers are disorganized, when there are no checks on weights and tests, and when there is no regulating influence on processing and purchasing margins.

9.

Tax Equality

Businesses operated by individuals, by partnerships, by cooperatives, and by small corporations are all taxed alike in that only one level of tax is imposed.

Large corporations are subject to a double tax. This is wrong. But extending the double tax to cooperatives and then, in turn, to small corporations, partnerships, and individual businesses is not the proper way to correct it.

Large corporations can use the tax advantages available to cooperatives if they choose to operate on a cost basis as cooperatives do.

10.

No Tax Issue in the Present Bill

There are no valid tax objectives to be achieved by the cooperative provisions of the pending bill.

All savings made by farmers when they market their produce, or purchase their farm supplies, on a cost basis, through their own cooperatives are taxed at full value to the members and patrons of the cooperatives. This is true, under the present law, regardless of what percentage is paid in cash or left in the cooperative as capital.

11.

Discriminatory and Destructive Legislation

The cooperative provisions of the pending bill are an unwarranted attack upon farmers cooperatives, and are designed to undermine their capital and financial structures, thus making it easier for processors and middlemen to reap a greater profit at the farmer's expense.

12.

The Federation's Position

We recommend that Section 531 be stricken from the bill for the following reasons:

(1) It serves no valid tax objective;

(2) It is a destructive and discriminatory attack upon farmers agricultural cooperatives;

(3) Its real effect would be to undermine the capital and financial structure of agricultural cooperatives;

(4) It would interpose the judgment of Congress for that of the farmer boards of directors of cooperatives;.

(5) It would prescribe an across-the-board rule which would be inflexible and inadequate to meet changing requirements;

(6) It is an attempt by Congress to interfere in the internal affairs of farmers' organizations;

(7) Problems relating to the internal operation of cooperatives should be considered by the agriculture committees and not the tax committees;

(8) As long as one full level of tax is currently paid, as it now is, farmers should be free to manage their own cooperatives and to finance them with their own money in whatever manner they deem best.

The Federation

The National Milk Producers Federation is a national farm organization. It represents dairy farmers and the dairy cooperative associations which they own and operate.

The policies of the Federation accurately reflect the viewpoint of dairy farmers who are members of cooperatives as well as the viewpoint of cooperative associations which dairy farmers have organized and joined.

This is true, because our bylaws require that at least 75 percent of the Federation's board of directors must be active dairy farmers. Attendance at our annual meetings, where our basic policy resolutions are determined, is predominately that of the active dairy farmer.

The men who serve on our board of directors, and those who serve as voting delegates when our policies are adopted, are all chosen, either directly or indirectly, by farmers and they must be responsive to the wishes and thinking of the dairy farmers they represent.

This is most important in this hearing, because it will be argued that Congress must protect farmers against their own cooperatives.

Farmers Control Cooperatives

The boards of directors of dairy cooperatives, in practically every case, are all active dairy farmers. The directors are elected by farmers, and they must be responsive to the welfare of the dairy farmers they represent and also to their own welfare as dairy farmers themselves.

The bylaws of the cooperatives require their boards of directors to be active farmers, thus assuring control of the cooperative by farmers. This further assures that the cooperative will be operated in the best interest of farmers and that its policies will reflect accurately the farmer viewpoint.

The principle of one-man one-vote is traditional with cooperatives, and democratic control by the farmers themselves is a fundamental concept in

these organizations. We know of no situation among our members, over many years of experience, where a few large producers have dominated a cooperative to the detriment of smaller producers. The one-man one-vote principle precludes this; and, in any event, farmers just don't operate that way in cooperatives. The reason they have combined together in a cooperative is to promote the common good of all through their united efforts.

The Farmers Freedom of Choice

The control which farmers exercise over the Federation and over their own cooperative associations, as we have pointed out, is most important to a proper evaluation of the issues presented in this hearing.

Some will argue that farmers must be protected against their own cooperatives and that, unless Congress intervenes, cooperatives will take unfair advantage of the farmers that own and control them.

This is the same as saying that farmers must be protected against themselves and that farmers must not be permitted to use their own best judgment in the management of their own affairs.

It will be our position, and that of the dairy farmers we represent, that farmers should be permitted to operate their own organizations, financed with their own funds, in whatever manner they deem best.

Congress should not undertake to substitute its judgment in the operation of a farmers' cooperative for the sound judgment and extensive knowledge and experience of its farmer members, who have at stake not only their own capital but also their own welfare and future as dairy farmers.

We are not impressed with the argument that Congress should protect the farmer against himself -- by making him do what he does not want to do -- and by making him handle his own business in his own organization in a manner which is contrary to his own best judgment and contrary to the wishes of a majority of his co-members.

An examination of the present proposal, along with similar proposals that have been made in the past, will disclose that the real objective of such legislation is not to help farmers but to undermine the effectiveness of agricultural cooperatives and thus enable nonfarmer enterprises to reap a greater profit at the expense of disorganized farmers.

This is particularly true of the pending legislation, because it serves no tax objective whatever. Its sole result would be to undermine the capital and financial structure of important agricultural cooperatives, thus leaving farmers at the mercy, if any such quality exists, of the purchasers and processors of their produce.

Farmers must be free to make their own decisions in their own cooperatives -- and Congress must not attempt to make decisions for them by a general rule of law -- because the facts are different in practically every case.

For example, in a new or expanding cooperative, or in one planning to set up a new plant, it might be most important to farmers to build up capital in substantial amounts and to leave capital funds in the cooperatives for a relatively long period of time. In a cooperative already fully financed, the farmers may prefer to withdraw a large percentage of their current savings in cash.

In one cooperative, farmers may prefer to take a large proportion of their current savings in cash and leave their invested capital in the cooperative for longer periods. In another, the farmers may prefer to leave their current savings on deposit in the capital of the cooperative in order to bring about a more rapid revolving of older capital certificates.

Business requirements change from year to year. The right to make business decisions must be flexible and not hampered by general across-the-board rules prescribed by Congress, which in many cases would be impractical to meet current problems.

As long as the current payment of one level of tax is adequately provided for, as it now is, we see no reason why farmers should not be permitted to make their own decisions concerning their own funds in their own organizations.

It is entirely out of order, and most inappropriate, in such cases, for Congress to substitute its judgment for the business decisions of the farmers and thus meddle in the internal affairs and operations of these important agricultural cooperatives.

What Are Cooperatives

Agricultural cooperatives are organizations of farmers who have banded together in an effort to improve their own economic lot.

They are entirely voluntary; and no farmer needs to join one, or to remain a member, unless he wishes to do so. In practically all cases, membership is open and any farmer who wishes to avail himself of the services of the cooperative and to participate in it is welcome to do so.

Cooperatives are a basic form of a self-help program in which farmers acting together seek to solve their own problems, improve the quality and service of their produce, and try to obtain a reasonable return for the labor and investment required to produce the Nation's food.

Some cooperatives are bargaining associations through which farmers can bargain as a group for the sale of milk to processing and distributing plants. Without such associations, farmers have no group bargaining power and are in the position of having to take for their milk whatever price the dairy companies may choose to pay.

Cooperatives also check weights and butterfat tests of the milk sold by their members, thus eliminating the possibility of false or inaccurate tests and weights.

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

Cooperatives also purchase for their members, on a cost basis, the supplies and equipment needed on their farms.

Congressional Approval of Cooperatives

There is a long history in Congress of legislation to encourage farmers to improve their own position by organizing and operating their own cooperatives. The policy of Congress in this respect is well established by many enactments. To mention just a few, the Capper-Volstead Act was passed in 1922, the Agricultural Marketing Act was passed in 1929, numerous provisions relating to cooperatives were enacted in the 1930's, and legislation relating to cooperatives and to the Farm Credit Administration has continued to the present time.

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

Cooperatives Help Farmers

Cooperatives have rendered a tremendously valuable service for agriculture over many years. Through them, farmers have provided services for themselves where needed services were not otherwise available.

They have kept processing and marketing margins in line by processing and marketing their own produce in their own plants when the margins charged by others were excessive. In the same manner, when prices charged for feeds and fertilizer and farm equipment have been excessive, farmers have set up their own purchasing operations.

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The savings farmers have made by performing their own marketing and purchasing services for themselves in their own cooperatives runs into many, many millions of dollars. This has benefited not only the agricultural economy of the Nation but the economy as a whole, because agriculture is an important part of the total economy.

Cooperatives provide a yardstick for measuring excessive processing margins and provide a brake on middlemen's excessive profits.

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

Farmers do not organize cooperatives for the fun of it. In most cases, they are driven to do so for their own protection, either because the services they need are not being provided or because excessive profits are being taken at their expense. Dissatisfaction with weights and tests is another factor. Unless there is a very real need for farmers to organize, the setting up of a new cooperative is quite likely to fail.

Cooperatives Are Important To Consumers

Although farmers' cooperatives have been reasonably successful in the agricultural field, as Congress intended them to be, they have neither achieved nor sought unreasonably high prices.

Controls against undue enhancement of prices are provided in Section 2 of the Capper-Volstead Act, but in actual practice it has never been necessary to use this section.

This country is so large, and its agricultural resources are so great, that cooperatives could not have unduly enhanced prices, even if they had desired to do so.

But cooperatives have not sought unduly high prices. Basically they have taken the position that prices should be at a level which would reflect to the farmer a fair return for his labor, taking into account the investment and risk involved.

Consumers have no right to enjoy food at prices which do not provide reasonable compensation to farmers any more than they have a right to enjoy industrial products made with sweatshop labor.

Hourly returns for the labor of dairy farm operators, as reported by the Department of Agriculture, have been far below $1.00 per hour in many of the past years. The most recent figures for the three test areas reported are $1.07, $1.08, and $.91 (Agriculture Information Bulletin No. 230, September 1968).

Actually cooperatives perform a valuable service to consumers by keeping middlemen's margins under reasonable control.

Furthermore, the cooperatives are an important and vital factor in the production of the abundant supplies of high quality foods which this country enjoys.

Opposition to Cooperatives

It is not difficult to see why farmers' cooperatives meet with strong opposition and why such determined efforts are made to hamper or destroy them.

As we have indicated above, the cooperatives provide a control on excessive processing margins and on excessive middlemen's profits, both with respect to farm marketing and the purchasing of farm supplies.

The opportunity for processors to take large profits is greatest when farmers are disorganized, when there are no checks on weights and tests, and when there is no regulating influence on processing and purchasing margins.

Tax Equality

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

Businesses operated by large corporations are double taxed, because one level of tax is charged to the corporation and another to its stockholders.

The same tax treatment that is accorded to cooperatives is available to big corporations if they choose to operate on a cost basis, as cooperatives do, and return to their patrons gross receipts less operating costs. In such a case, no profit would accrue to the big corporation and there would be no corporate tax. Cooperatives must operate on a cost basis and no profit can accrue to the cooperative.

All of the savings made through the operation of a cooperative must be passed back to its patrons, and the patrons are taxed on all such savings currently and at the full amount.

The double tax on corporations is wrong, and it should be gradually eliminated. It would merely compound the wrong to extend a double tax to cooperatives and then, in turn, to small corporations, partnerships, and individual businesses.

No Tax Issue In The Present Bill

There is no tax issue in the present bill, insofar as it applies to farmer cooperatives.

All savings made by farmers when they market their produce, or purchase their farm supplies, on a cost basis, through their own cooperatives are fully taxed to the members and patrons of the cooperative.

This tax is charged currently, without deferment, and all such savings are taxed at full value. This is true whether the farmers elect to receive their savings in cash or to leave them invested in the cooperative as capital funds of the cooperative.

The tax result is unchanged, whether the savings paid in cash is 20 percent or 50 percent, because the farmer pays taxes currently on the full value of his share of the savings made.

There is, therefore, no valid tax objective to be achieved by the cooperative provisions of the pending bill.

Discriminatory and Destructive Legislation

The cooperative provisions of the pending bill are highly discriminatory and destructive and serve no useful tax purpose.

They are an unwarranted attack upon farmers' cooperatives, and are designed to undermine their capital and financial structures.

As long as one full level of tax is being paid currently by farmers on the savings made through their cooperatives, there is no valid basis for Congress to meddle in the internal affairs of the cooperatives.

Neither is there any valid basis for Congress to substitute its judgment for the business judgment of the farmer boards of directors of agricultural cooperatives. These men are well informed and they are farmer oriented. They know what is best for themselves as farmers and for the successful operation of their cooperatives.

An across-the-board rule imposed by Congress without knowing the day-to-day and year-to-year needs of each individual cooperative would be dangerous and ill-advised.

There is no need to protect the farmer from his cooperative, because the farmer controls the cooperative and membership in it is voluntary. A cooperative

whose capital and financing arrangements did not have the support of its membership could not possibly survive.

We are not impressed by those who profess to want to help the farmer by undermining one of his most effective tools, his own cooperative.

This legislation is a thinly disguised attempt to permit processors and middlemen to take unwarranted and excessive profits from the farmer by crippling the farmers ability to perform services for himself, when such margins get out of hand.

The Federation's Position

The Federation, and the dairy farmers we represent, have consistently supported the principle that one level of tax should be paid currently by farmers on the savings they make when they process their own produce through their own cooperative plants on a cost basis.

We have vigorously opposed, and continue to oppose in this bill, attempts to undermine the capital and financial structure of cooperatives under the guise of tax legislation.

We recommend that all of Section 531 of H. R. 13270, relating to Agricultural Cooperatives, be stricken from the bill for the following reasons:

(1) It serves no valid tax objective, since it neither increases nor decreases the tax liability of cooperatives or farmers or in any way changes the tax revenue as a whole;

(2) It is a destructive and discriminatory attack upon farmers agricultural cooperatives, wholly unwarranted by any valid tax objective;

(3) It is designed to undermine agricultural cooperatives by impairing their capital and financial structure in a manner not necessary to any revenue purposes;

(4) It undertakes to impose the judgment of Congress for that of the farmer boards of directors of cooperatives;

(5) It prescribes an across-the-board rule which does not take into consideration the fact that the capital requirements of cooperatives vary as between cooperatives and also vary from time to time in the same cooperative, depending upon its expansion and building programs;

(6) It is an attempt by Congress to interfere, unnecessarily, in the internal affairs of farmers' organizations;

(7) If there were any problems relating to the internal operation and financing of cooperatives, this would be a matter for the consideration of the agriculture committees and not the tax committees of Congress;

(8) As long as one full level of tax is being paid currently, as it now is, farmers should be free to manage their own cooperatives and to finance them with their own money in whatever manner the farmers prefer and in whatever manner the farmers themselves, in their own sound judgment, deem best for themselves as farmers and best for their cooperatives, which are so very important to them.

STATEMENT OF IRVING CLARK
BEFORE THE
COMMITTEE ON FINANCE, UNITED STATES SENATE
SEPTEMBER 22, 1969

I am Irving Clark of the law firm of Doherty, Rumble & Butler of Saint Paul, Minnesota. This statement is made on behalf of Farmers Union Central Exchange, Inc., Farmers Union Grain Terminal Association, Great Plains Supply Company, Land O'Lakes Creameries, Inc., Midland Cooperatives, Inc., Northern Cooperatives, Inc., North Star Dairy, Twin City Milk Producers Association, and the Minnesota Association of Cooperatives. Those organisations conduct marketing and farm supply activities for farmers primarily in Wisconsin, Minnesota, Iowa, North Dakota, South Dakota, Montana, Washington, and Idaho. They are owned by approximately 2800 local cooperatives and approximately 800,000 individual rural patrons.

My firm is also General Counsel for National Federation of Grain Cooperatives, a federation of 20 regional grain marketing cooperatives which are farmers' marketing organizations serving approximately 2,800 local grain marketing associations. You have already heard testimony on behalf of that organization and its members. I am authorized to say that it also concurs in the opinions I am about to express.

After a thorough and careful consideration by Committees and the Congress, the Revenue Act of 1962 established a fair and workable basis for taxation of cooperative earnings. It accepted the principle that earnings of cooperatives should be taxed either to the cooperative or the patron, but not both. It required that the cooperative pay at least 20 per-cent of its patronage distributions in cash, and obtain the consent of the

recipients to treat the entire dividend as income--or else the cooperative would pay tax on its entire earnings.

Following enactment of the 1962 Act, tens of thousands of cooperatives amended their by-laws and took other steps to comply with the Act. Their patrons have been paying the income taxes on patronage dividends contemplated by the Act.

In other words, the 1962 Act is working. Now Section 531 of the Tax Reform Bill would add new and impossible burdens to those placed on the cooperatives by the 1962 Act.

If the purpose of this legislation is to destroy cooperatives, it will succeed in its purpose.

If the purpose is to help the American farmer, it will fail miserably.

The Congress has repeatedly established that farm cooperatives are essential to American agriculture. Those experienced in the cooperative movement are now using that experience to assist urban cooperatives--in the ghettos of our big cities and wherever the problems of the poor can be aided by the American principles of self-help.

This bill would bring about the liquidation of that essential tool needed for both agricultural and urban workers--the cooperatives.

It must be, we conclude, that those who voted for the insertion in the Bill of Section 531 thought they were "helping the patron."

It is our purpose to show you in what respects they were mistaken.

Section 531 is not a revenue-producing measure. The objective was stated to be to put a bigger portion of the earnings of the cooperatives

into the hands of the patrons, in cash. The Report of the Committee on Ways and Means says in part:

> "Farmers today have little dominion over the treatment of patronage dividends despite the fact that they must pay tax on them as if they did."

This rests upon the illusion that the patrons want the cash, but their cooperatives are withholding it--as though by a small group of willful directors. But there is no such situation in the cooperatives. Unlike the case of a business corporation, each stockholder or member of the cooperative typically has one vote, regardless of the number of shares held. They elect directors personally known to them, who share their views. They attend the annual meetings. If a majority of them insist upon a large proportion of earnings being paid in cash, they have the power.

So--the patrons control the cooperative. They have power to decide how much of its earnings the cooperative shall pay in cash. Legislation to compel an increase will simply bust the cooperatives. Some will go broke sooner than others, but it is only a question of time for all of them--if this provision is enacted.

In the guise of helping the patron, it will force liquidation of a tool he needs--now more than ever.

How is this so? It is a matter of cash requirements--of pressing needs for capital.

Of the approximately 2800 local cooperatives which are the owners and patrons of the groups for which I appear, two-thirds have earnings of

$25,000 or less. As with all small businesses, annual earnings do not come in the form of cash. They are soaked up in increased accounts receivable, in increased costs of facilities, and in increased investment in the regional cooperatives.

Traditionally, the capital for these requirements has been provided by patrons agreeing to reinvest their patronage dividends in the cooperative. The patrons have not had spare cash. But they have been willing to let the cooperative treat their patronage earnings as a reinvestment, after paying 20 per cent in cash to the patrons to enable them to pay their income taxes. This is because the cooperatives have been a needed source--in many places, the only source--of supplies, of marketing services, and of other services.

The cooperatives need to retain the largest part of their earnings, as they are not able to attract cash investments in the way a business with profit potential for investors, can. In other words, they are a service, a tool, not a profit venture.

Two-thirds of our local cooperatives have net earnings of $25,000 a year, or less. A sample of 400 of the stronger ones showed that their net earnings had increased very slightly during the last five years. Many of the 2800 cooperatives have been barely able to survive, using 80 percent of their earnings during the last five years for capital needs and redemption of older outstanding equities. The Bill would permit them to retain only 50 percent. Yet an ordinary business corporation earning $25,000 or less can retain 78 percent of its earnings, and usually does.

The problem is compounded by the provision that the cooperative must obligate itself to redeem all non-cash dividends within 15 years from date of issue. Our typical local cooperative has more than ten years' past equities outstanding. In order to be in position to redeem in 15 years those equities issued hereafter, many of them must first redeem all of their present equities during the next 15 years. They are required to by their by-laws, and by simple principles of fairness. That requirement, plus the 20 percent cash payout, will require a total cash payout of 85 percent of average earnings. That is impossible.

It is impossible for the local cooperative because it is necessary to plow back somewhere between 50 and 80 percent of earnings into inventories, receivables, and facilities just to keep even.

This brings us to the regional cooperatives. It is charged that these organizations are giants, expanding into manufacturing, oil refining, and other enterprises and competing unfairly with private business. The fact is that the "regional" or "federated" cooperative is made up of local cooperatives which own it and control it. They have banded together to extend their purchasing power, or marketing power. To allow farmers to join together in the ownership of a petroleum storage tank and a delivery truck while denying them the right to join together in the ownership of an oil refinery is to deny both history and the facts of modern economic life. Local farmers' cooperatives have always been provided services and supplies through regional cooperatives. Nearly all business organizations have had to grow larger in recent years in order to be competitive, and farmers' regional cooperatives have had to grow with them in order to survive. The regionals' cash tied

up in receivables, inventories, and facilities has also increased, and the amount of their cash has correspondingly declined. Most important, any regional cooperative, no matter how well managed, can have a loss year. That means that they will be unable to redeem patronage refunds previously issued, which cuts down still further the flow of cash to the local cooperatives.

All this comes down to the proposition that Section 531 of the Bill is based on a series of fallacies:

> The fallacy that earnings are cash.
>
> The fallacy that there are no prior claims on that cash which is in fact realized--such as outstanding debt, or equities which the cooperative is obligated to redeem ahead of the new ones.
>
> The fallacy that cooperatives don't have to acquire new facilities and equipment in order to provide services to keep their members alive.
>
> The basic fallacy that Congress will help the patrons by putting their cooperatives in a straight-jacket.

We urge that Section 531 should be stricken from the Bill.

APPENDIX TO STATEMENT OF IRVING CLARK

ANALYSIS OF COOPERATIVE PROVISION (SECTION 531)

OF TAX REFORM BILL OF 1969

This analysis has been prepared on behalf of the following cooperatives, their 2800 local cooperatives, and their over 800,000 individual rural patrons:

Farmers Union Central Exchange, Inc.

Farmers Union Grain Terminal Association

Great Plains Supply Company

Land O'Lakes Creameries, Inc.

Midland Cooperatives, Inc.

Northern Cooperatives, Inc.

North Star Dairy

Twin City Milk Producers Association

and the Minnesota Association of Cooperatives.

This statement is intended to give factual information regarding the effect of the provisions of Section 531 of the Tax Reform Bill of 1969, H.R. 13270, and to show the fatal damage it will do to many cooperatives.

1. What the Bill Provides

The entire proposed change of law as it relates to cooperatives is contained in one Section of the Bill--Section 531. It would amend only one section of the Internal Revenue Code, Section 1388. The present Section 1388 contains various definitions of terms used in Sections 1381 through 1388, IRC, which with Section 521 set forth the tax status of cooperatives. One of those definitions is a complex one, defining the term "qualified written notices of allocation." A portion of the definition, subsection (c)(1) of Section 1388, now provides that at least 20 percent of the amount of the patronage dividend distributions of a cooperative must be paid to the patrons in cash, and certain other requirements must be met, or the document representing the balance of the patronage dividend (sometimes called the "non-cash portion") will not be a "qualified written notice."

The Bill would amend that definition by adding two requirements:

New Requirement One. The amount paid out in cash must increase at the rate of 3 percent a year until 50 percent is reached. This amount of increase is called in the Bill "the applicable percentage," and it is stated at 3 percent for taxable years beginning in 1970, 6 percent for those beginning in 1971, etc., until it reaches 30 percent for years beginning in 1979 or any subsequent year. Together with the existing 20 percent, the applicable percentage makes a total of 50 percent of current earnings which must be paid out in cash for years beginning in 1979, and thereafter.

While the present 20 percent in cash now required must be paid out as part of the current patronage dividend, that is not true of the "applicable percentages," or increased amounts. They may either be paid out in cash as part of the current patronage dividend, or be paid out in cash

"in redemption . . . of any qualified written notice of allocation" previously issued.

<u>Comment</u>. We are informed that this may not have been the intent of the framers, but the provision as now drawn has the effect of limiting redemptions which would be credited against the "applicable percentages" to redemptions of documents issued in 1964 or later. Older documents which may have been distributed prior to 1964 are not "qualified written notices of allocation" within the present Code definitions nor in the Bill. This would mean that although a cooperative may have older evidences of patronage distributions outstanding, and may be obligated by law or by its by-laws or other contractual arrangement to redeem them before it can redeem the 1964 and later documents, such redemptions would not "count" toward the "applicable percentage." This disadvantage, which perhaps could be corrected by a change of wording, is pointed out here as a matter of construction or interpretation of the language of the Bill. Correction of it by altering the language would <u>not</u> correct the drastic hardships imposed by the Bill--see below.

<u>New Requirement Two</u>. The Bill also adds to the definition of "qualified written notice of allocation" a requirement that the issuing cooperative must be obligated to redeem the "written notice" in cash within 15 years. The <u>obligation</u> may be created in either of two ways:

(a) The cooperative may adopt a by-law so providing, with a further provision that this obligation cannot be changed "without the consent of those adversely affected;" or

(b) The written notice may be in the form of "an unconditional written evidence of indebtedness . . . which matures within such 15-year period."

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The Bill also requires that "qualified per-unit retains" issued by a cooperative include the same obligation of redemption within 15 years, either by by-law or by being in the form of an evidence of indebtedness which matures within 15 years. Thus, those cooperatives which use the method of distribution of earnings called "retains," or "capital retains," or "per-unit retains" would be subject to the same new requirements as those cooperatives which use the patronage dividend method alone--namely, the required increase in the percentage of earnings paid out in cash, until it reaches 50 percent (see below as to the true effect of this), and also issuance of obligations with fixed maturities of 15 years or less.

2. The Provisions of the Section Would Not Work

Many of the illustrations in this analysis are based upon published summarized data covering 400 farm supply cooperatives. These cooperatives are not typical, but are among the strongest of the 2,800 cooperatives in the upper Midwest. The harsh impact of the provisions of Section 531 would apply with even greater force to the 2,400 weaker cooperatives not covered by the published data. The data covering these 400 cooperatives is set forth at the end of this analysis as Exhibit A.

A. Most of the 2,800 local cooperatives in the upper Midwest have annual earnings of less than $25,000. Such organizations cannot be expected to survive under a 50 percent cash distribution requirement.

Available information on these upper Midwest local cooperatives indicates that 65 percent of them had annual net earnings of less than

$25,000 each. The vast majority of them are small businesses operating in small rural communities. They were organized by their patrons, and perform a vital function as a source of supplies, of marketing services, and of other services at reasonable prices.

Like all small business organizations, nearly all of their relatively small annual earnings may be required in a given year for the repayment of loans or for the replacement of facilities and equipment. Inflationary pressures alone result in the necessity for additional working capital to finance larger dollar amounts of receivables and inventories.

The Congress has long recognized the economic necessity for small businesses to retain a major portion of their earnings, by the smaller corporate tax rate of 22 percent on the first $25,000 of net income. This is especially true in the case of cooperatives, which cannot attract equity investments motivated by profit potential.

The effect of the proposed 50 percent cash requirement on a cooperative with annual earnings of $20,000 would be as follows:

	Annual Earnings	Income Tax	Cash Distributions	Retained Earnings
Current Rules				
Ordinary corporation	$20,000	$4,400		$15,600
Cooperative	20,000		$ 4,000	16,000
Proposed Rules				
Ordinary corporation	$20,000	$4,400		$15,600
Cooperative	20,000		$10,000	10,000

Thus this provision of the Bill would allow the small cooperative to "plow back" into its operations less of its earnings than an ordinary business of the same size. This is not good economics, good tax policy, nor good farm policy, as well as being obviously unfair to the cooperative.

B. Section 531 of the Bill appears to be based on the erroneous assumption that, in the case of cooperatives, "annual earnings" are somehow equivalent to "additional cash."

Section 531 imposes arbitrary cash distribution requirements on cooperatives based upon patronage dividends which are annual earnings. These cash requirements are stated at 50 percent, but together with the 15-year revolving requirement, they may easily amount to 100 percent, as will be illustrated later.

Nearly all cooperatives in our area are business organizations handling inventories of farm produce or of supplies. Under the provisions of the Internal Revenue Code they are required to compute earnings on the "accrual" basis. They are not on the cash basis of accounting.

There is no necessary correlation between accrued earnings and cash. In individual cases 100 percent of accrued earnings may be represented by a combination of increased inventories, increased accounts receivable, additional facilities, or reduced debt.

Nevertheless, under Section 531, they would be required to make cash distributions of from 50 percent to 100 percent of annual earnings regardless of the amount of available cash.

The data on 400 local cooperatives illustrates a 52 percent increase in earnings tied up in non-cash forms, in a period of five years. These increased items were accounts receivable, inventories, facilities, and investments in their regional cooperatives.

Portions of the above increases were financed by increased liabilities. However, the example illustrates the dramatic changes that can occur

in any business organization, with substantial amounts of earnings reflected in a non-cash form.

These changes are compelled by necessity. Technological changes in farming, such as increased numbers of classes of fuel, increased kinds and mixes of fertiliser, chemicals and other supplies have compelled local cooperative associations to put additional money into facilities.

The Regulations under Section 537 of the Code give full recognition to all of the above factors for accumulation of earnings to meet the reasonable needs of the business, in the case of an ordinary business corporation, in the following words:

"(b) <u>Reasonable accumulation of earnings and profits</u>. Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable ends of the business provided the general requirements under §§ 1.537-1 and 1.537-3 are satisfied:

"(1) To provide for bona fide expansion of business or replacement of plant;

"(2) To acquire a business enterprise through purchasing stock or assets;

"(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

"(4) To provide necessary working capital for the business, such as, for the procurement of inventories; or

"(5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation." (Reg. §1.537-2(b))

Section 531 of the Bill, contrary to this Regulation and to all business experience, equates annual earnings with ability to make cash distributions.

C. In the case of the fairly level earnings experienced by most cooperatives in recent years, the 15-year redemption provision amounts to an impossible requirement of annual cash distributions of up to 100 percent, which in a great many cases will begin at once, rather than in 15 years.

Despite substantial increases in sales volume, the published data on 400 strong local supply cooperatives shows relatively level average earnings during the past 10 years:

OPERATIONS (averaged) (400 local cooperatives)	1958	1963	1968
	(thousands omitted)		
Sales to patrons	$243	$308	$445
Local operating earnings	$ 14	$ 13	$ 13
Regional patronage dividends	$ 14	$ 19	$ 22
Net earnings (averaged)	$ 27	$ 33	$ 35
Percent to sales	11.2 percent	10.7 percent	7.9 percent

During 1968 the above cooperatives issued patronage dividends of approximately 20 percent in cash and 80 percent in qualified notices. Assuming continuation of the trends of the past 10 years from 1970 through 1985, these

cooperatives would face a 100 percent cash distribution requirement in 1985:

Assumed net earnings in 1985		$ 35,241
Cash distribution requirements:		
20 percent of 1985 net earnings in cash	$ 7,048	
Qualified notices of 1970 (80 percent of 35,241)	28,192	35,241 100 percent

The necessary cash would simply not be available unless all of the following impossible assumptions were made for 1985 and all subsequent years:

> 100 percent of the dividends received from regional cooperatives were in cash; accounts receivable did not increase; inventories did not increase; no replacements or additions were required for facilities and equipment; all patrons' equities issued prior to 1970 had already been redeemed.

Local cooperatives are owned and controlled by their patrons. In general, they have followed the equitable procedure of retiring patronage equities in the order of their issuance--oldest first. It can be fairly assumed that they would desire to continue this procedure. Many of them are obligated to do so by provisions in their by-laws. To do so (in order to retire such presently-outstanding equities before the compulsory redemptions called for by the 15-year requirement of the Bill), the 400 cooperatives covered by the data would somehow have to make average annual redemptions of the following dimensions beginning in 1969:

Assumed net earnings for 1969		$ 35,241
20 percent of 1969 net earnings, in cash	$ 7,048	
1/15th of presently outstanding patronage equities of $344,925, in cash	22,995	30,043 85 percent

An 85 percent cash distribution can not be made because none of the

necessary assumptions are true for 1969. In other words, it is simply not true that the dividends from the regional cooperative are all in cash. It is not true that the accounts receivable, inventories and facilities investments fail to increase. On the other hand, they must inevitably increase.

In at least one state (Wisconsin), a dairy marketing cooperative is required by law to maintain a ratio of current assets to current liabilities of 1.25. The issuance of notices of allocation with a fixed maturity will alter that ratio adversely, putting the cooperatives subject to that law into receivership within the first few years.

Thus, the 15-year requirement has immediate impact on the many cooperatives of our area which are already obligated to retire their oldest outstanding equities first. It will force them to strive to retire those existing equities at a pace they cannot achieve or maintain, with many inevitable failures far sooner than 15 years.

D. Recent business trends have diminished the ability of increasing numbers of cooperatives to revolve patrons' capital on any sort of predetermined basis.

The ability of any business organization to make cash distributions is not determined by either net earnings or by cash on hand. Assuming no plans for facility additions and no shortages of working capital, it is determined by the "acid test" ratio: The ratio of the total of cash and accounts receivable to current liabilities.

This concept applies in the case of cooperatives and of ordinary business organizations. The factors involved are ignored by Section 531 of the Bill, even though they are given full recognition in the Regulations under the present Section 537 of the Internal Revenue Code, determining

whether accumulations of earnings by ordinary corporations are reasonable or unreasonable.

As indicated previously, the data on the sample of 400 strong local cooperatives reveals increasing amounts of capital tied up in receivables, inventories, facilities and investments in regional cooperatives during the past 10 years. During the past 10 years these strong cooperatives have, on the average, been able to make cash distributions and redemptions averaging 50 percent of their total earnings, but the ability to continue such payments has been markedly diminished, as these figures show:

"Acid Test" Ratio (Averaged) (400 local cooperatives)	1958	1963	1968
Cash and receivables	$49,989	$69,915	$83,284
Less current liabilities	18,435	26,524	74,197
Available for cash redemptions, investments & facility additions	$31,554	$43,391	$ 9,087

Average 1968 earnings were $35,241 and non-cash patronage dividends distributed averaged $28,192.

Further analysis shows that 155 of the 400 "strong" cooperatives had no excess cash and receivables, and would be unable to make any cash redemptions without further increasing their present financial difficulties.

By disregarding such changes in overall business trends and changes in financial ability of individual cooperatives, the requirements of Section 531 would render insolvent the majority of the 400 strong local cooperatives covered by the summarized data, and even more certainly, the majority of the 2400 cooperatives not covered by the data.

E. The Bill ignores the fact that as a matter of economic necessity substantial portions of the annual earnings of individual cooperatives are represented by increased investments in regional organizations.

Local farmers' cooperatives have banded together to form regional organizations to provide them with marketing services or a source of farm supplies at reasonable prices. The regional organizations are a necessary extension of the operations of the local cooperatives.

In the case of the 400 farm supply cooperatives, earnings developed through their regional organizations have increased to over 60 percent of their total average earnings. To develop their sources of supply at reasonable costs the patrons, who first joined together in the ownership of petroleum storage tanks and delivery trucks, have had to join together in the ownership of interests in oil refineries and pipelines.

The maintenance of these regional organizations is essential to the operation of the local cooperatives. The necessary investments to finance these organizations have increased substantially in recent years to finance increased working capital needs and more complex and costly facilities and equipment. Regional cooperative investments account for approximately half of the capital investments required of the patrons of local cooperatives.

The regional organizations have obtained the cash needed for their facilities investments, receivables, etc., by retaining a portion of the cash and distributing the equivalent in "qualified written notices of allocation." To require the regionals to increase their distributions to an

ultimate 100 percent cash would result in their insolvency and the loss of both the regional investments and the necessary part they play in the operation of the local cooperatives.

Changing economic conditions of recent years (higher volume, lower margins, increasing costs of facilities) have seriously reduced the ability of the regionals to make cash distributions of as much as 50 percent. Consequently, a major part of the total earnings of each local cooperative has been in the form of non-cash earnings, which diminishes its own ability to make cash distributions of a major part of its own total earnings.

Furthermore, any regional cooperative, no matter how well managed, can have a loss year. Two of the regionals in our Midwestern group have had loss years within the last five years, and it can happen again. That means that they will be unable to redeem patronage refunds previously issued, even though they may have a "due date" under the provision of Section 531 of the Bill.

F. The arbitrary cash distribution provisions of Section 531 ignore the business needs of individual cooperatives to repay necessary loans, replace facilities and equipment, build up working capital, or to meet unforeseen financial problems.

The ability of any business organization to make substantial cash distributions is determined by its financial position and not by its annual earnings. By ignoring this fact, Section 531 of the Bill becomes a possible source of eventual insolvency to all cooperatives under certain circumstances.

The following table shows that even the healthiest of the three cooperatives, Cooperative A, will be trapped by the obligations imposed by the Bill, and will be unable to meet those obligations in spite of an increase in annual earnings. Cooperative B, having level earnings, will be even farther behind. Cooperative C, whose earnings have dropped, will fail that much sooner:

	Co-op A	Co-op B	Co-op C
Annual earnings: 1970	$10,000	$10,000	$10,000
1985	$20,000	$10,000	$ 5,000
1985 earnings represented by increased accounts receivable, increased inventories, investments in regionals, replacements of equipment, payments on long-term debt	$12,000	$12,000	$12,000
Cash available for distributions and redemptions	$ 8,000	$(2,000)	$(7,000)
Section 531 requirements:			
a. At least 50 percent in total, or,	$10,000	$ 5,000	$ 2,500
b. 20 percent of total 1985 earnings	$ 4,000	$ 2,000	$ 1,000
Plus redemption of 1970 non-cash distribution	$ 8,000	$ 8,000	$ 8,000
	$12,000	$10,000	$ 9,000
Total cash shortage in 1985	$(4,000)	$(12,000)	$(16,000)

While these particular cases are hypothetical, the factors which cause the failures are not hypothetical. The data on the 400 strong local cooperatives shows that average financial positions of such organizations have been seriously weakened in recent years.

As a group, they face increasingly severe financial problems under present conditions. This is clearly shown by the data for the 400 strong

local cooperatives and applies with even more force to the 2400 weaker local cooperatives not covered by the data. For example, the 400 cooperatives are strong supply cooperatives. A sample of grain marketing local elevators showed a decline of 31 percent in local earnings in the five years 1963 to 1968. At the same time the regional to which they belong suffered a decline in earnings of 40 percent. A similar sampling of dairy cooperatives showed a decline of 11 percent in combined local and regional earnings in the same period. This is a highly critical period of time in the financial affairs of cooperatives and their patrons.

It would be indeed ironic if Section 531, in the name of aid to the patrons, is allowed to wreak financial havoc upon such cooperatives resulting in the loss to patrons of the necessary service they require together with their accumulated investments in these organizations.

G. The arguments advanced in favor of the provision are mistaken.

The Staff Report of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, dated August 18, 1969, attempted to summarize "Arguments For" and "Arguments Against" Section 531 of the Bill (page 93).

The first "Argument For" reads:

"(1) By requiring the cooperative to pay to the patron all of the patronage dividends within fifteen years, the Bill assures the patron that he will eventually receive the patronage income on which he has been taxed.

In fact, the Bill assures the patron nothing of the sort.

Instead, it requires that all patronage dividends not paid in cash shall be in the form of fixed obligations due within fifteen years or sooner. Since the effect of this provision must be the eventual replacement of all of the equity capital of each cooperative with a form of long-term debt with a fixed due date, the more probable result is to assure the patron that he will lose both the services of his cooperative and all of his accumulated investments in it in some future year when it has low earnings or a loss, causing its insolvency and forced liquidation. The report recognizes this to a degree in its "Arguments Against," saying:

"(4) The requirements for an early payout of patronage dividends and retains will impair the working capital of the cooperative, since these amounts represent, in effect, the cooperative's equity capital and serve as a base to support its borrowings."

The second "Argument For" reads:

"(2) Farmers today have little dominion over the treatment of patronage dividends despite the fact that they must pay tax on them as if they did. The Bill will give them full control over one-half of the patronage dividend immediately with assurances that the remaining one-half (retained by the cooperative) will be paid out to them in 15 years. This greater control over the income on which they are taxed makes the tax more equitable."

This is simply not so. The patrons _do_ have control, unlike the situation in an ordinary business corporation.

Dominion over treatment of patronage dividends is vested in Boards of Directors of members elected by members at annual meetings with one vote

per stockholder. Most local cooperatives have less than 500 members. Their directors are neighbors who share their viewpoints and are personally known to most of them. Their control and voice in the affairs of their cooperative is real, unlike that of stockholders of large business corporations.

Patrons of a local cooperative who pay the tax on their share of the earnings of the cooperative do so voluntarily under the 1962 Act. They have consented to this tax treatment voluntarily. Under the 1962 Act they may withdraw their consent if they are not a member, or revoke their membership if they are a member, and the cooperative will pay the tax on their share of the earnings. They are aware of this right but, except for a very small number of cases, have not withdrawn their consents.

Through their elected Directors, the members of each cooperative currently do have full control of the patronage dividends taxed to them. The Directors are able to determine the amount of cash that needs to be retained to meet the needs of the business and the amount available for payment to farmer patrons in the form of distributions and redemptions. This is reported to the members at well-attended annual meetings, and the members accept the decision because it is based on the facts.

The third "Argument For" reads:

> "(3) By requiring cooperatives to pay out more of their income currently the amounts they can retain tax-free for expansion of facilities in competition with fully tax-paying businesses is lessened. This is a desirable way of limiting the tax-free growth of business enterprises."

This is mistaken policy, and unfairly discriminatory. Ordinary corporations, under current law, are required to pay income taxes at the rate of 22 percent of the first $25,000 of taxable income and at the rate of 48 percent of their taxable income in excess of $25,000. Ordinary corporations are not required to make any payments to stockholders of earnings required in the operation of their business.

Two-thirds of our local cooperatives have earnings of less than $25,000 per year. They are now required to pay out 20 percent of the amount of their patronage dividends in the form of cash. Under the proposed Bill they would be required to pay out 50 percent of their earnings in the form of cash. The result of this is that the cooperatives will be able to retain a maximum of 50 percent of their earnings for the needs of the business--and often less. Ordinary business corporations of comparable earnings will, on the other hand, be able to retain 78 percent.

That this discriminatory policy is a mistaken one is well stated in the "Arguments Against" as follows:

> "(2) The Bill ignores the role farm cooperatives play in improving the incomes of farmers by providing them with alternative methods of marketing their crops or of acquiring farm equipment, machinery and supplies at reasonable prices.
>
> "(3) There is no showing that the present balance between farm cooperatives and regular businesses should be upset to the detriment of the cooperative movement."

It is a myth that cooperatives and regular businesses are "in balance;" cooperatives are, in fact, losing ground. While active business corporations

as a whole gained 52.4 percent in sales in the period 1960 to 1966, farmer cooperatives gained 29.6 percent. Statistical Abstract of the United States, 1969, Tables 694 and 903.

3. Summary

a. The Bill requires a "phased" step-up in percentage of earnings paid out in cash from 20 percent to 50 percent in ten years. It also requires that the cooperative issue non-cash patronage dividends in a form which it is obligated to redeem within 15 years.

b. These provisions would not work:

A. Most of the local cooperatives have annual earnings of $25,000 or less. Their cash requirements are in excess of 50 percent of their earnings. A business corporation having earnings of the same level is permitted to retain 78 percent of the earnings.

B. It is erroneous to treat "annual earnings" as equivalent to "cash." They come to the enterprise tied up in the form of assets, and remain tied up in such form.

C. In the case of fairly level earnings, the requirement for redemption in 15 years has the effect of forcing annual cash distributions in excess of 50 percent, often 100 percent of earnings. This will begin in the near future, not in 15 years.

D. The ability of cooperatives to revolve patrons' capital on any "due date" basis is diminishing, rather than increasing. The legislation would put them in a straitjacket.

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E. The investments in regional organizations are a matter of economic necessity for the local cooperatives.

F. The cash distribution requirements of the provision ignores existing debt and other business needs.

G. The arguments advanced in favor of the provision are mistaken and illusory.

END OF APPENDIX

SUMMARIZED DATA ON 400 LOCAL SUPPLY COOPERATIVES

	1968	1963	1958	5 Year Increases 1964-68	5 Year Increases 1959-63
FINANCIAL POSITION (Averaged)					
Current Assets:					
Cash	$ 28,149	$ 33,963	$ 28,918	$ (5,814)	$ 5,045
Receivables	55,135	35,952	21,071	19,183	14,881
Inventories	89,693	49,671	38,508	40,022	11,163
Prepaid expense	1,643	1,040	754	603	286
	$174,620	$120,626	$ 89,251	$ 53,994	$ 31,375
Less Current Liabilities	74,197	26,524	18,435	47,673	8,089
Net Working Capital	$100,423	$ 94,102	$ 70,816	$ 6,321	$ 23,286
Investments, primarily regional cooperatives	171,821	134,996	86,499	36,825	48,497
Facilities & equipment	98,386	52,353	33,612	46,033	18,741
Less long-term debt	(25,705)	(9,481)	(4,890)	(16,224)	(4,591)
Patron Equities (Owned by Patrons)	$344,925	$271,970	$186,037	$ 72,955	$ 85,933
OPERATIONS (Averaged)					
Sales to patrons	$445,797	$308,371	$243,525	$137,426	$ 64,846
Gross margins	$103,996	$ 69,594	$ 52,633	$ 34,402	$ 16,961
Operating expenses	90,641	56,221	39,039	34,420	17,182
Local operating margins	$ 13,355	$ 13,373	$ 13,594	$ (18)	$ (221)
Patronage dividends from regional cooperatives	21,886	19,478	13,672	2,408	5,806
Net Earnings	$ 35,241	$ 32,851	$ 27,266	$ 2,390	$ 5,585
Per cent to sales	7.9%	10.7%	11.2%	(2.8)%	(.5)%

EXHIBIT A

PART B—ADDITIONAL STATEMENTS

Summary of the Statement of
Charles Davenport on
Farm Tax Losses
Before the Senate Committee on Finance
September 22, 1969

I appear in my own capacity as a citizen interested in equitable tax laws and represent no other person in making this statement.

Farm tax losses raise a problem of tax equity and foster unfair competition for many of America's farm families which must rely on farm income for a living.

The farm tax loss problem arises from the combination of (1) a unique administrative dispensation permitting the reporting of farm income and expenses on a cash basis and (2) the conferring of capital gain treatment on some farm assets.

This benefit is available to a taxpayer who (1) has a "farm tax loss" which is not an economic loss and (2) substantial non-farm income against which to absorb the "farm tax loss." There is no benefit to one who has only the farm investment. Thus, high bracket non-farm taxpayers enjoy a competitive advantage over farmers.

There are three proposals to deal with this problem:

(1) The authority to use cash accounting and to deduct some expenses which are capital expenditures could be revoked. I would urge this solution.

(2) Section 211 of H.R. 13270 proposes an excess deductions account which would convert certain sales of farm assets from capital gain to ordinary income. This proposal does nothing to prevent the offsetting of artificial farm losses against other income. It thus permits a deferral of tax on current income and is a wholly ineffective means of dealing with the problem.

(3) If the solution set out in paragraph (1) above is not adopted, I urge adoption of S.500, herein called the Metcalf Bill. It is structured to reach only artificial farm losses, and it denies current deduction of them.

The present scheme is highly inequitable since it permits many high bracket taxpayers to shield their ordinary income from tax. More importantly it subsidizes by reduction of taxes on other income the "tax farmer" and puts him at an unfair competitive advantage over the "legitimate" farmer.

The Metcalf Bill should be adopted by Congress to solve the "farm tax loss" problem.

Statement of Charles Davenport
on Farm Tax Losses

Before the Senate Finance Committee
September 22, 1969

GENERAL INTRODUCTION

This statement discusses several pending proposals for changes in the income tax treatment of income from certain farm investments. Before turning to the substance of this discussion, permit me to identify myself.

I teach Federal income tax law at the School of Law, University of California at Davis, California. I represent no client nor organization in writing this statement. I am writing it solely in my own capacity as a citizen with special knowledge of taxation and an interest in an equitable tax system. I have had what I think is unique experience working with the taxation of farm investments. From 1960 to 1967 I was in practice in San Francisco, California, with a firm that represented many farm investors and operators. During that time I was a member, Vice chairman, and Chairman of the Committee on Agriculture of the Tax Section of the American Bar Association. From May 1967 until August of 1969 I worked in the office of the Tax Legislative Counsel in the Treasury Department. During the time that I was with the Treasury Department, I participated in the consideration of many and in the development of two proposals concerning the farm tax loss problem, including that contained in "Tax Reform Studies and Proposals," which was published by this Committee and the House Committee on Ways and Means, and including the proposal recommended by the Treasury when it appeared before the House Committee on Ways and Means in April of this year.

THE PROBLEM

There is a general consensus that there is a farm tax loss problem. The House Committee on Ways and Means devoted an entire day to the discussion of this subject. The hearing record runs 1?5 pages. The Committee heard presentations from at least 15 different groups and printed in the record innumerable letters and comments from persons who did not appear before the Committee. All of these persons agreed there was some difficulty in the farm tax area, but there were differing opinions as to the nature of that difficulty. The purpose of this statement is to help in explaining what I believe to be the nature of the farm loss problem and to discuss the various solutions now pending.

The farm loss problem arises from two different provisions of the Federal tax law. One of them is an administrative decision made as early as 1915 which provided that farmers could report their income on either the cash or the accrual method of accounting, whether or not such method accurately reflected income. It also permitted farmers to deduct their livestock raising costs even though these were capital expenditures. Subsequently, in regulations promulgated in 1919, the Treasury also authorized farmers to write-off capital expenditures incurred in the development of orchards and ranches. Thus, very early

in the administration of our tax law, farmers were accorded liberalities not accorded to any other industry. They could use cash accounting and expense capital expenditures even though these dispensations violated proper accounting rules and distorted the reporting of income.

At the time that these rules were developed, they may have been defensible on the ground that the identification of specific costs attributable to particular products on hand at the end of the year would have been difficult. Furthermore, the accounting principles then available were unsophisticated and probably not prepared to deal with the problem of segregating and capitalizing costs associated with livestock and assets such as farms and orchards. In addition, there seems to have been some notion that the average farm did not represent the type of financial investment usually found in other business operations. Thus, farming was looked at as a way of life rather than as a business, and it seemed inappropriate to require the use of highly developed accounting techniques even if they had been available.

It is interesting to note that these rules developed before there was any concept of capital gain. They were also developed by an administrative agency which was charged with prescribing accounting rules which would properly reflect income. Expediency undoubtedly was their chief justification, and there seems to have been no consideration as to their impact on investment and farm assets. Indeed, such consideration would have been improper by an administrative agency charged with the collection of a tax on income. But even so, it is doubtful that they had any such impact at that time.

In 1942, Congress expanded the category of assets entitled to capital gain treatment to include property used in the trade or business where there was a net gain for the year on such assets. After some period of controversy, the law was clarified to make clear that livestock held for draft, breeding or dairy purposes for a period in excess of 12 months qualified under this provision. The controversy then moved to a determination of whether the particular animal had been held for one of these purposes. The courts interpreted the section very favorably to taxpayers and conferred capital gain in a number of circumstances which may not have been within the intendment of the law. The result is that a substantial part of the farm profits realized in certain types of farming operations are now reported as capital gain while the cost of the assets yielding that capital gain have been fully written off.

The consequences of this interaction of fully deductible capital costs and the reporting of proceeds as capital gain have been fully explored and cogently summarized by the National Livestock Tax Committee in a letter to Honorable Wilbur D. Mills, Chairman, House Committee on Ways and Means, dated March 23, 1969. (This letter appears in Tax Reform, 1969, Hearings Before the Committee on Ways and Means, House of Representatives, 91st Congress, 1st Session, at page 2056 and following). The illustration there assumes a "typical commercial cattle operation" which yields an economic profit of some $22,500 over a five-year period. However, after application of the present income tax laws which create "farm tax losses" while also taxing the sales proceeds at capital gain rates, there is a total net reduction of taxes on other income (derived by

subtracting the net capital gain tax from the savings in tax resulting from the "farm tax loss") in the amount of $56,344. This is referred to as a "tax profit," i.e., a payment from the U. S. Treasury to the taxpayer through the tax system. Thus, the taxpayer's overall gain is approximately $79,000.

There are two striking features about this overall gain. First the "tax loss" generated from the raising of the livestock is of no value to one who has no other income. If the taxpayer is engaged in no endeavor other than that of raising livestock, the "tax loss" is of no benefit. Thus, the "tax profit" is available only to those persons who have substantial other income. Secondly, although there has been a "tax loss" there also has been a true economic farm profit of nearly $23,000, and the taxpayer who has this outside source of income has paid no tax on that farm profit. Instead, this taxpayer has received additional payments in the form of reduced taxes on other income in the amount of nearly $57,000 from the Federal government. On the other hand, a taxpayer who had only the livestock income would have paid some taxes on the $23,000 farm profit earned over the five year period. The exact amount would depend upon the taxpayer's personal exemptions and itemized deductions. Thus, the taxpayer having non-farm income has a competitive advantage over the taxpayer who had only the farming interest. This advantage, arising solely by reason of the tax law, is $57,000 on an investment which yielded an economic profit of only $23,000.

Contrast this also to a taxpayer engaged in the grocery business. If he earned $23,000 over a five year period, he would also pay some tax. Thus, taxpayers having both (a) non-farm income and (b) certain kinds of farm investments which produce "farm tax losses", also have a substantial advantage over taxpayers engaged in other businesses.

Thus, the taxpayer who has the happy combination of large non-farm income and certain farm investments which produce "farm tax losses" is granted an inequitable advantage over (1) those farm taxpayers who have no other income and (2) those taxpayers who have only non-farm income. In the former case, this advantage is also an unfair competitive advantage which permits the "tax farmer" to obtain higher profits on lower prices. The "tax farmer" thus is in a position to drive the "legitimate" farmer out of business. Any change in the tax law, then, should have the purpose of removing the unfair competition between farming interests having outside income as compared to those farming interests which have no outside income. In addition, such change should remove the inequity between farmers and non-farmers.

POSSIBLE SOLUTIONS

From time to time there have been suggestions for changes which would accomplish the goals just described. Perhaps the simplest of these would be the outright revocation of authority for taxpayers having farm income to use the cash method of accounting where it does not accurately reflect income and also to deny to them the right to expense certain capital costs such as the cost of raising livestock or developing orchards, vineyards, and ranches. There are a number of practical problems in this approach, but none of them is insoluable. This approach has much to commend it and is theoretically the correct one. If this Committee should decide to move in that direction, it certainly

would be taking a proper action which would be a substantial reform of the income tax law. It is the action I would recommend. If this Committee does not, however, desire to adopt such a sweeping reform, it undoubtedly will go on to consider two other pending proposals. The first of these is embodied in section 211 of H.R. 13270. The Treasury Department has recently made recommendations to modify this provision. The other proposal is that contained in the bill introduced by Senator Metcalf on January 22 of this year, S. 500.

The solution adopted by the House is a four part solution. The first is to require that to the extent that the "farm tax loss" exceeds $25,000 it be entered into an excess deductions account if taxpayer's non-farm income for the year is in excess of $50,000. Second, the House voted to extend the holding period on livestock receiving capital gain to one year beyond the time from which such livestock is placed in service by the taxpayer. Third, the bill provides for a recapture of depreciation on livestock so as to place it on an equal footing with other personal property. The second and third actions are appropriate and should be taken regardless of any other provisions which this Committee may choose. They do not, however, solve the farm loss problem. Fourth, the House revised some of the so-called hobby loss rules. They apply to all businesses of any kind. Since their application is not limited to farming, there is no reason to discuss them in the context of the farm loss problem. It seems appropriate thus to exclude them from our present discussion. This leaves us with the excess deductions account, which certainly is the major plank in the farm loss program. We shall compare it to S. 500.

The excess deductions account (herein referred to as EDA) adopted by the House would appear to be a most ineffective tool because it fails to recognize that the major difficulty in the farm tax area is the ability to deduct currently, against non-farm income, expenses which are capital expenditures. By so doing, the "tax dodge farmer" continues to create artificial farm losses which reduce his taxes on current non-farm income. Now under EDA it is true that at some later date, he may be required to include in ordinary income the receipts from the sale of certain farm assets which, absent the EDA provision, he would return as capital gain. But the subsequent returning as ordinary income amounts deducted in prior years permits the taxpayer to defer taxes on current income earned from sources other than farming. The consequence of all this is that in an industry where profits are relatively low, and I understand that in livestock farming total economic profits are often claimed to be as low as 3%, the ability to defer taxes on the income earned in the other endeavors is an extremely valuable benefit. Indeed, the ability to defer taxes may be more valuable than a complete exemption from tax. A simple example will illustrate this.

For the purposes of this illustration, the income and loss limitations contained within the bill are ignored because they are given special consideration below. Thus, we can assume that in the first year the taxpayer incurs a $100 raising cost on a breeding animal which he will ultimately sell at capital gain rates. He incurs the same expense in the second year, and in the third year he sells the animal for $210. His economic profit thus is $10 (or 5%). If he had been required to capitalize the raising costs and to pay a capital gains tax on the profit element only, his tax would be but $2.50. Under present law and under EDA, however, the taxpayer may deduct the raising costs of $200.

Assuming a 70% tax rate, in the first year he would reduce his taxes on other income in the amount of $70. The same would be true for the second year when he would reduce his taxes on other income in the amount of $70. These reductions in tax are in essence an interest free loan. Under EDA, the taxpayer would be required to repay the interest free loan upon sale of the animal in the third year when EDA would recapture the prior deducted expenses at a $140 tax cost, just equal to the total of the taxes on other income saved in the first two years. In addition, there would be a $2.50 capital gain tax on the profit. The net tax cost thus is the capital gains tax on the profit. But in addition, the taxpayer has had the benefit of an interest free loan from the government. The value of this loan, assuming an interest rate of 6%, ridiculously low at current borrowing rates, is $12.60. The net benefit is the value of this loan ($12.60) reduced by the capital gains tax ($2.50) or $10.10. This may be contrasted to $2.50 benefit which the taxpayer would have realized if he had capitalized his costs and not been required to pay a tax on the profit. Clearly, then the value of deferring taxes on income earned in other endeavors may exceed the value of entirely exempting farm profits from tax. Any EDA proposal, or any other proposal, which operates on the basis of permitting taxpayers to continue to defer current taxes by the deduction of capital costs is excessively generous and does not handle the farm tax loss problem. Finally, since the repayment of the interest free loan from the Government depends upon a sale by the taxpayer, he has within his own hands the ability to decide when the loan should be repaid, certainly a strnge position for a debtor.

In addition, the bill as it came from the House, had two further difficulties. One of them seems to be irremediable. When farm assets are transferred in non-taxable transactions, there either must be a transfer of EDA to the transferee or the transferee is in a position to sell the assets at capital gain rates while the transferor will have deducted the capital cost of the assets against ordinary income tax rates. Due to the myriad kinds of transactions, it is impossible to devise a single workable rule which will adequately prevent this kind of manipulation. Thus, the bill has a hodge-podge of rules which are neither rational nor curative. They may, however, be the best that can be devised to deal with an insoluable problem. Secondly, the income and loss limits of the bill are such that it would operate on approximately 3,000 tax returns. As far as can be ascertained, this would be about .1% of one percent of all farm tax returns and less than one-half of one percent of farm tax returns showing a farm loss. The long run revenue estimate is something less than $20 million. The almost negligible effect of these estimates undoubtedly led the Treasury to recommend that the outside income limit on the bill be reduced to $25,000 and that the farm loss be reduced to $15,000. The Treasury estimated that as so modified, the bill would affect 9,300 taxpayers and in the long run raise $50 million of revenue.

In concluding the discussion of EDA, let me point out that however modified EDA will be ineffective. It is premised on the belief that the payment of taxes one, two, or ten years from today is the same as the payment of taxes today as the income is earned. We all know this is not so, and deferral of paying taxes is now the "name of the game" for many highly skilled tax practitioners. Even if every dollar of farm loss were entered into EDA by every farmer in America, the substantial period of deferral and the benefits to be derived therefrom would render EDA ineffective to solve the farm tax loss problem. Thus, even if modified as suggested by the Treasury EDA will remain an inappropriate tool to deal with this problem.

In contrast to this rather ineffective proposal, Senator Metcalf has introduced S. 500, which is now pending before this Committee, I believe, as Amendment No. 139 to H.R. 13270. That bill would achieve the objective of removing the tax subsidy from tax loss farming by limiting to $15,000 (or the amount of the "special deductions" mentioned in the bill, whichever is higher) the deduction for a farm loss which the taxpayer could use to offset non-farm income. Generally speaking, a farm loss would be the amount by which farm deductions exceeded farm income. For these purposes, the untaxed one-half of long term capital gains attributable to farm property would not be included in income. Farm deductions will include all deductions attributable to the farming business. If the taxpayer's non-farm adjusted gross income exceeded $15,000, the limit on his deductible loss would be reduced by $1 for each $1 of such excess. On the other hand, this limit would be raised to the amount of the taxpayer's "special deductions" if it were higher. The special deductions are (a) taxes, (b) interest, (c) abandonment, theft, fire, storm or casualty losses, (d) drought losses and expenses, and (e) losses on the disposition of assets to the extent they are attributable to farming. If the farm loss of any year is greater than the allowable amount, it would be reduced by the untaxed portion of farm capital gains in that year and then be available to be carried backward three years and forward five years to offset farm income in other years. Partners and shareholders in corporations electing to be taxed under sub-chapter S of the code would then be treated as engaged in the farming operation of the partnership or corporation. It also provides that if a taxpayer is engaged in farming and one or more businesses which are directly related to this farming and conducted on an integrated basis with his farming, the taxpayer could elect to treat all such businesses as a single business of farming.

Finally, a taxpayer who elected to report income using inventories where significant and to capitalize capital expenditures would not be subject to the foregoing rules limiting the amount of this farm loss but could deduct it in full if there were no other provisions of the law which would disallow the deductions. It does not require anyone to adopt accrual accounting. As is mentioned below only 15,000 (out of 3,000,000 farmers) taxpayers would be faced with the choice of non-deduction of the farm tax loss on the use accrual accounting. The purpose of the bill is to preserve cash accounting for those farmers who have not made excessive use of the liberal accounting rules.

This bill offers as good a solution as can be devised short of requiring that all farmers use accrual accounting and be denied the right to deduct capital expenditures. By exempting all losses of less than $15,000 from the operation of the bill, it assures that the small farmer who must supplement his income from other sources or take part time or seasonal employment will not be subject to its provisions. However, this $15,000 limitation is not a blank check to all taxpayers to make deductible investments of $15,000 per year. Instead, as the adjusted gross income exceeds $15,000, the amount of the allowable loss is reduced so that

at $30,000 of non-farm adjusted gross income, no farm loss is allowable. This seems clearly appropriate and is a necessary tool to render the bill fully effective. Also, any so-called legitimate farmer who satisfies the reasons for the special accounting rules will not have as much as $15,000 to $30,000 of non-farm adjusted gross income. The bill thus is a cleverly devised bill for which Senator Metcalf is to be complimented. If this Committee is not prepared to require accrual accounting and full cost capitalization where necessary to reflect income properly, I cannot urge too strongly that this Committee adopt the Metcalf Bill as a reasonable solution to the farm loss problem. . . Let me add, however, that there are a few changes which you may want to consider. They are discussed in the Appendix. They merely improve what would be a good tool.

One might take a look at the bill's operation. It would probably affect about 15,000 taxpayers and would raise as much as $200 million in revenue. This is only about one-and-one half percent of the total returns showing farm losses, but this group obviously are the taxpayers who are taking excessive advantage of the present tax law. The deferral of taxes on current income would be denied to this group, but if they, or for that matter any other farmer, have any sort of catastrophic loss that could not be absorbed by current farm income, it could be carried over and carried back against farm income of other years. Additionally, most deductions which produce true economic losses are special deductions which are allowed even if they exceed the $15,000 loss limitation. They are taxes, interest, abandonment, theft, fire, storm and casualty losses, and drought losses and expenses and losses on the sale of assets. Thus, the charge that this bill would operate in any arbitrary fashion so as to disallow economic losses cannot be established. Rather it operates only after allowance of the enumerated deductions. It attacks the farm loss problem directly, and it tends to disallow only those artificial losses which would arise from the deduction of capital expenditures that is now permitted under present law.

The amount of revenue raised and the number of taxpayers affected by these various bills are not, of course, the sole criteria by which to measure the effectiveness of provisions dealing with the farm loss problem, however. Obviously, they do, however, go to the question of whether the proposal reduces the Federal subsidy going to taxpayers who have the kind of farm investment which produces a "farm tax loss" which is not an economic loss while also having other sources of income. It must be remembered that this subsidy does not provide any benefits to those who have only the farm investment producing the "farm tax loss." Thus, the purpose of any proposal in this area would be to discourage some investment in farm assets by placing those taxpayers who have substantial outside income on the same ground as those who have only farm income. When measured by this criterion, there is no doubt but what the bill passed by the House even if amended as recommended by the Treasury would be wholly ineffective while the Metcalf Bill at least would have a substantial impact which would appear to be effective. On the other hand, EDA would continue to permit a substantial deferral of taxes on current income for a large number of taxpayers.

CONCLUSION

A number of arguments defending the present provisions of the tax law were raised in the hearings before the House Committee on Ways and Means. To a large extent these are economic questions which claim that the present system yields a large "incentive" to invest in farm assets. It is doubtful that this incentive is desirable in light of our other farm programs designed to assist those most harmed by the tax subsidy. In addition, the "incentive," or more properly the "subsidy," questions the integrity of the tax law and perverts our concept of tax equity. Reduced to its barest form, the argument for this tax incentive is that persons having substantial non-farm income should be induced to invest in certain farm assets and receive the Federal subsidy described above. They are thus accorded a substantial competitive advantage over persons who must rely on only farm income and who therefore do not receive the tax subsidy. To anyone seriously interested in the family farm and its economic well being, it seems clear that the tax law should be amended to reduce this unfair competition. One must, then, view these statements by the defenders of the present system with somewhat of a jaundiced eye. They can be made only to defend a system which is highly inequitable in its operation and which benefits only those who have very high taxable incomes.

The Metcalf Bill would reduce, if not eliminate, this unfair competition. The capital which remained in farming could compete on equal terms whether it is supplied by one having large non-farm income or is supplied by one who must rely on the farm for his sole livelihood. The overall result should be a healthy re-introduction of the unsubsidized free enterprise system in the farm area.

It seems to me that we would all applaud such action and that this Committee would receive the thanks and commendation of millions of farmers throughout the country who today are struggling against Federally tax subsidized competition by high income taxpayers who need not rely on the farm to produce a profit, but rather can look to the Federal Government to supply a profit on the farm investment through the reduction of taxes on other income. There is no justification for the present system, either in terms of equity in the tax system or providing incentive in terms of inducing or strengthening the family farm.

APPENDIX

Suggested Improvements in the Metcalf Bill

The operation of the bill could be improved by the following changes:

(1) Losses on ordinary assets (as distinguished from section 1231 assets) might be included in the category of specially treated deductions. Such losses are true economic losses, and there is no reason to disallow them. The failure to include them would appear to be mere inadvertence. Such losses probably would not occur in many cases, for most of the farm assets producing ordinary income either have no basis or are held in an inventory. In the former case, a loss could not be realized on the sale, and in the latter case the taxpayer probably would not be subject to the bill in any event because he would qualify under the provision excepting taxpayers using inventories and capitalizing capital expenditures.

(2) The provision permitting a taxpayer to treat a nonfarm business as a part of his farming operation if it is related to and on an integrated basis with the farm business raises a definitional problem in determining whether the two operations are related on an integrated basis.

This problem could be cured by providing that a business would not be considered as related and conducted on an integrated basis with the farming operation unless it consists of the processing of a product raised in the farming operation. Furthermore, the sale of such processed product should produce a substantial portion of the total receipts of the over-all operation. In addition, the provision should make clear that treating the two businesses as a farming operation would be for the purposes of this bill only, i.e., measuring the size of the "farm loss" to ascertain whether certain deductions are allowable. The bill should clearly preclude the

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treating of the other business as a farm operation for the purpose of adopting accounting methods, the filing of estimated tax returns, the filing of final returns, and the like.

Even with this modification, however, the bill might fail to achieve its goal and would permit the offsetting of some "farm losses" arising from the farm tax accounting rules against income earned in other business. For example, a taxpayer might be engaged in processing frozen orange concentrate from an orange grove on which large expenditures and consequent "farm losses" were incurred because a part of the grove had not yet reached full production. The grove, as a whole, presumably would meet all the tests set out above. Thus, the special benefit of deducting "farm losses" against other income would be continued for those taxpayers who have the capital and resources which would permit them to operate in a business related and integrated with their farming operations. Thus, with respect to such taxpayers the bill would not accomplish its objectives even though they would not appear to be the type of taxpayer for whom the special accounting rules were devised.

Thus, even if modified as suggested, the bill might not accomplish its purpose. Yet, the treating of separate businesses as a single operation departs from the usual practice in administering the tax law and may raise problems neither foreseen nor forseeable at this time.

(3) A number of taxpayers may purchase breeding herds, depreciate them for a short period, sell the herd and realize substantial capital gains on the excessive depreciation. While this practice appears improper, there may be an enforcement problem arising from the inability of the Internal Revenue Service to audit all taxpayers. The enforcement problem could be solved automatically by including livestock in the recapture provisions under section 1245. Logically, there is no reason to exempt

livestock, and it would prohibit finagling with depreciation even though the taxpayer elected accrual accounting in order to avoid application of the bill.

(4) Under the bill the farm loss would be permitted to offset other farm income, and it may also be carried over to other years. In neither case does farm income include the untaxed portion of capital gains. A loss of $50 may thus continue to offset $100 of capital gain income in either the year of loss or when used as a carryover. This difficulty could be removed by requiring the loss to first be applied against ordinary income, and any balance then applied against capital gain income before the section 1202 deduction or before application of the alternative capital gain rate. The same treatment would be prescribed for carryovers. Thus, in the case where the farm capital gains in the current year are $100 and the farm loss is $50, the capital gain would be reduced to $50 on which a tax would be paid. If there were also ordinary farm income of $20, the farm loss would be reduced to $30, and the farm capital gain would be $70. Exactly the same treatment would be accorded carryovers. For example, if the current loss is $50 with no capital gain until the following year when $100 of farm capital gains are realized, the $50 loss carryover would reduce the capital gain to $50 on which a tax would be paid.

An alternative to the suggested treatment would be to require that the farm loss to be an adjustment to the basis of assets. This would necessitate deciding whether to adjust the basis of ordinary income or capital gain assets. It could also raise administrative problems if depreciable property were involved by presenting a new depreciation base each year. If, however, the alternative of a basis adjustment were chosen, presumably the adjustment would not be permitted to create losses but only to reduce gains to zero.

SENATE COMMITTEE ON FINANCE
HEARINGS ON H.R. 13270
TAX REFORM ACT OF 1969
STATEMENT OF WILLIAM O. DALEY, C.P.A.
TAXATION OF COOPERATIVES
SECTION 531

SUMMARY OF PRINCIPAL POINTS

The fifteen year redemption provision of section 531, respecting taxation of cooperatives,is, for the following reasons, inadvisable and should not be adopted by the Committee:

1) It would tend to make it more difficult for cooperatives to finance their operations adequately.

2) It would present cooperatives with an arbitrary redemption requirement unrelated to business realty.

3) It would force cooperatives into increased borrowings and, thus, make their financial situations less stable.

The statute should be amended to permit payments in cash as well as qualified per-unit retained certificates, so that the cash payments, in common with the certificate payments, are deductible during the taxable year if made within 8-1/2 months after such year.

SENATE COMMITTEE ON FINANCE
HEARINGS ON H.R. 13270
TAX REFORM ACT OF 1969
STATEMENT OF WILLIAM O. DALEY, C.P.A.
TAXATION OF COOPERATIVES
SECTION 531

My name is William O. Daley. I am licensed as a Certified Public Accountant in the states of Florida and Arkansas and am the senior member of W.O. Daley & Company, Certified Public Accountants, with offices in Orlando and Vero Beach, Florida. We specialize in cooperative accounting and tax practice, and represent approximately 80 percent of the cooperatives in Florida as well as some sizable cooperatives outside of Florida. Our office in Orlando, Florida, was established in 1944.

I would like to place before the Committee, on behalf of my firm and our cooperative clients, our considered jugments respecting H.R. 13270's section 531 which proposes certain changes in the taxation of cooperatives.

A. Fifteen Year Redemption Requirement.

The proposal requires that written notices of allocation and per-unit retain certificates be paid in money within fifteen years after issuance. We believe that the proposal, if enacted, would create a particularly hazardous situation for most, if not all, cooperatives.

1. Financing Difficulties.

The fifteen year pay-out requirement would cause a transfer of the cooperative members' investment (represented by the notices of allocation and per-unit retain certificate) from the equity section of a cooperative's balance sheet to the long term liability section. Thus, the provision would make it almost impossible for these organizations to obtain proper financing. This difficulty would exist even for those cooperatives which may follow a practice of revolving the certificates over a ten or twelve year period. It is quite certain that financing institutions, such as the Bank for Cooperatives which makes sizable loans to cooperatives, would require a subordination of the fifteen year paper by each cooperative member holding such paper. Without such subordination, it is exceedingly likely that long term loans will not be made. In fact the subordination may often be required for short term loans. Considering the fact that cooperatives have normal changes in membership, the task of obtaining subordinations from a majority of members can often be insurmountable.

2. Arbitrary Effect of Forced Redemptions.

The fifteen year pay-out requirement would present particular difficulties for cooperatives that have wide variations from year to year in the amount of patronage

dividends (notices of allocation), and/or per unit retains distributed. My firm has a number of farm cooperative clients in which the unit volume and dollar value of products marketed fluctuates as much as 50 percent from year to year. This fluctuation, which can be caused not only by the normal variation in the size of the annual crop but can be accelerated by the presence of hurricanes, freezes, dry weather, wet weather, short labor supply and other factors, may, thus, force irrational redemption requirements on a cooperative during a year when that cooperative is experiencing wholly different business conditions.

Under the present procedures, without the arbitrary fifteen year pay-out requirement, a cooperative will redeem its paper if, as and when its financial condition permits. In addition, under current conditions a specific year's certificate may be redeemed in segments over a period of years. The current rule therefore fits snugly with the economic conditions as they exist and change from year to year. Cooperatives are not strait jacketed but may exercise reasonable judgment in securing their economic positions.

3. Forced Borrowing.

The mandatory fifteen-year redemption provision is not only arbitrary in that it does not adequately recognize the year to year variations in a cooperative's

performance and experience, but operates in a similar arbitrary manner in that it does not recognize the fluctuations in general economic conditions. For example, in many cases in order to meet redemption obligations, cooperatives will doubtless be forced to borrow additional monies from other institutional sources. In effect, such cooperatives will be placed at the mercy of the money markets and may be required to incur increasingly high interest rates and other unpalatable restrictions simply because of a statutorily directed redemption of their certificates. The net result of the higher cost to the cooperative will be a further reduction in the relatively low return to the farmer for his farm product.

Of perhaps more serious consequence is the fact that farmers' cooperatives today have difficulty in obtaining long-term financing from any source other than Banks for Cooperatives. If the cooperatives, by virtue of the fifteen year redemption requirement, put excessive borrowing demand pressure on the Banks for Cooperatives, such institutions may find that they do not have the resources to make all loans that may be necessary. Thus, certain cooperatives may be placed in the impossible position of being required by statute to redeem their

paper and not have any reasonable possibility of obtaining the funds with which to make such redemption. The resulting condition would be no less than chaotic.

In view of the difficulties as described above, which may be caused by the enactment of section 531, we urge upon the Committee that the fifteen year redemption provision be struck from the bill which will be reported to the floor of the Senate.

B. Cash Payments in Lieu of Per-Unit Retains.

Moving, if we may, from the fifteen year redemption situation to a condition that exists under current law, we invite the committee's attention to a matter which we feel has a sizable arbitrary effect and needs immediate correction.

Under existing law, a marketing cooperative operating on a pooling basis can distribute to its members qualified per-unit retain certificates and receive the benefit of a deduction against ordinary income in the face amount of such certificates. At the same time the recipient member reports the face amount of the certificate in taxable income in the year in which he receives it.

The statute contains no specific guidance on the question of when such a qualified per unit retain certificate

must or may be redeemed. It would appear that such a certificate may be redeemed by the payment of cash at any time on or after issuance. The cash might, conceivably, be paid to the member simultaneously with the issuance of the certificate or soon thereafter.

Alternatively, although the statute would seem to permit this quick redemption and conversion to cash, it does not permit an immediate direct payment of cash in lieu of a qualified per-unit retain certificate in a manner which would have the same retroactive deduction consequence, i.e., deductible in the prior taxable year if paid within eight and one-half months after the end of the year. This inconsistency is not merely arbitrary, as measured against a standard of pure logic, but results (1) in a totally unnecessary administrative burden (through the issuance of the interim paper) and, in most cases, (2) in the placing of a liquidity squeeze on the member.

The development of such a squeeze can be illustrated as follows: For technical reasons, the per-unit retain certificate for a given year cannot be distributed until the completion of the audit of the pooling cooperative's books and records for that year. This normally does not occur, at its earliest until 60 to 75 days after the conclusion of

the year. Then it becomes necessary to prepare and mail to members the per-unit retain certificates. Following this step, the cooperative may redeem the certificates for cash.*/

This entire process of audit, issuance of certificate and redemption for cash may often not be completed until four or five months following the end of the taxable year. During that time the member is deprived of the funds represented by the certificate and must obviously use alternative and much less favorable sources of financing in his farm business.

In order to avoid this anomaly and the unnecessary difficulty which it entails, we would urge that the statute be amended to permit the deductible issuance, at any time within the eight and one-half month period, of not only qualified per-unit retain certificates, which will subsequently be redeemed for cash, but also direct cash payments in lieu of such qualified certificates. Under this procedure cash could be distributed to members (in lieu of the certificates) immediately following the end of the taxable year. We are attaching to this statement an exhibit showing suggested statutory language to accomplish this proposal.

Thank you.

*/ Although the statute does not direct itself to the point, the Internal Revenue Service has taken the informal position that redemption of such certificates may not occur at any time prior to 30 days following issuance.

SENATE COMMITTEE ON FINANCE
ATTACHMENT TO STATEMENT OF
WILLIAM O. DALEY
HEARINGS ON H.R.13270

Section 1382(b)(3) (relating to the determination of the taxable income of cooperative organizations) is amended to read as follows:

"(3) as per-unit retain allocations, to the extent paid in money, qualified per-unit retain certificates (as defined in section 1388(h)), or other property (except per-unit retain certificates (as defined in §1388(g)) which do not constitute qualified per-unit retain certificates) with respect to marketing occurring during such taxable year; or"

* *

Section 1388(f) (relating to the definition of per-unit retain allocation) is amended to read as follows:

"(f) PER-UNIT RETAIN ALLOCATION.- For purposes of this subchapter, the term 'per-unit retain allocation' means any allocation, by an organization to which part I of this subchapter applies, including payment in money, per-unit retain certificates, or other property to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron."