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TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED THURSDAY, SEPTEMBER 25, 1969

PART B.—ADDITIONAL STATEMENTS

(Topics: Limit on Tax Preferences; Allocation of Deductions; Tax Treatment of State and Local Bond Interest; Income Averaging; Maximum Tax on Earned Income)

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

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Summary of Statement by the Honorable C. Douglas Dillon
Before the Senate Finance Committee on H. R. 13270
September 25, 1969.

1. Privately financed, non-profit institutions such as schools, colleges, hospitals, museums and symphony orchestras provide an important and unique source of strength to our country.

2. The great bulk of our privately financed, non-profit institutions must rely on large givers for 70%-80% of their fund raising. They customarily receive 70% or more of their contributions in the form of appreciated securities or property.

3. For the past fifty years, large scale, private giving to charity has been fostered by governmental policy which has consistently permitted such gifts, at their full current value, to be deducted from adjusted gross income up to a ceiling which has been 30% of adjusted gross income since 1954.

4. The allocation of deductions provision of H.R. 13270, insofar as it applies to charitable gifts, removes a substantial part of the tax benefit from all gifts to non-profit institutions. Its effect on large scale giving will be devastating.

5. A tax computation for a model taxpayer, proportionately similar to my own tax return, has been prepared by Price Waterhouse and Co. It shows that 40.1% of the taxpayers' gifts to charity would no longer be deductible under H.R. 13270. The overall tax to be paid by the model taxpayer would increase by 24.2%. Of this increase 88.8% would be due to the treatment of charitable gifts under the allocation of deduction provisions. The taxpayer can totally eliminate the impact of this increase by reducing his charitable gifts.

6. Donor-taxpayers have full control of their own giving. By reducing their gifts they can avoid the impact of the allocation of deduction provision. Thus this provision cannot fairly be called tax reform since it will do little or nothing to equalize the tax burden.

7. The model shows that a reduction in giving of 87% would be required to eliminate the impact of the allocation of charitable deductions, and to leave the donor-taxpayer in the same economic position after gifts and taxes, as would be the case under present law.

8. The modification suggested by the Treasury eliminating the classification of the appreciation on securities given to charity as so-called tax preference income is a step in the right direction, but it only removes a maximum of 13-1/2% of the model taxpayer's problem.

9. The substantial reduction in large scale charitable giving that will occur, if the allocation of charitable contributions is required, will force practically all non-profit institutions to turn to government for support or to go out of business. To avoid this most undesirable result the entire allocation of deduction provision, so far as it applies to charitable giving, should be stricken from the bill.

10. Support for Treasury proposals to reduce the tax on foundation income from 7-1/2% to 2% and to allow credit for the appreciation in value of works of art given to museums.

Statement of the Honorable C. Douglas Dillon
Before the Senate Finance Committee on H. R. 13270
September 25, 1969

I am here today to testify in opposition to the provision in H. R. 13270 regarding the allocation of charitable deductions. This provision requires that deductions of charitable gifts be allocated proportionately between taxable income and so-called tax preference income. The result would be that charitable deductions would no longer be fully deductible from adjusted gross income as at present.

Our present system of full deductibility for charitable gifts has been in effect for my entire adult life and longer.* It has lead to a growth, unknown elsewhere in the world, in privately financed schools, colleges, hospitals, museums, operas and symphony orchestras as well as in other more specialized charitable organizations. This, to me, is one of the unique strengths of our free enterprise system. Over the past two generations it has produced results unparalleled in other countries, where such institutions are almost invariably under the control of governments. If provision for the allocation of charitable deductions contained in H. R. 13270 were to be enacted, it would mean the end of the privately financed aspect of practically all these institutions. Sooner or later they would have to receive the bulk of their support from government or go out of business.

The provision for allocation of charitable deductions contained in H. R. 13270 is actually a major piece of social legislation directed against all privately financed charitable institutions. It should be recognized as such, and could well be known as the Death Sentence for privately operated charitable institutions. This is strong language but I mean every word of it, and I feel certain that the facts support my position.

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*1917 - 15% of taxable income computed without regard to charitable contributions.
1942 - 15% of taxable income computed without regard to charitable contributions and medical expenses.
1944 - 15% of adjusted gross income.
1952 - 20% " " " "
1954 - 30% " " " "

I speak today in my capacity as President of the Board of Overseers of Harvard College, as a Vice President of the Metropolitan Museum of Art, as a Governor of the New York Hospital, as Chairman of the Brookings Institution and as a member of the governing boards of a number of other non-profit institutions. I do not speak as a complaining taxpayer for the impact of this provision can be readily avoided by any individual merely by reducing or eliminating his charitable donations. Thus this provision should not be thought of as tax reform. For it does nothing to spread the tax burden more evenly. It does not introduce greater equity into our tax system. It will raise little or no revenue, and will not increase the tax burden of the wealthy, all of whom can and most of whom will reduce their charitable contributions as necessary to avoid or minimize any additional burden. As a result its impact on charitable giving is likely to be devastating.

Certainly it is fully within the prerogatives of the Congress to enact legislation of this nature. The Congress may feel that our social system should be radically revised; that the government should take over the financing of all hospitals, universities and cultural institutions. If this is the opinion of the Congress, then this legislation is appropriate to carry out the Congressional will and should be enacted. If Congress, however, feels, as I most intensely do, that our privately financed, non-profit institutions are a vital source of strength to our society, and should be preserved, this provision for the allocation of charitable deductions should be stricken from the bill. Above all, such a far reaching social change should never be made under the false impression that it is tax reform and therefore good.

In considering this matter, we should always be aware of two things. First, charitable contributions are a voluntary matter, wholly subject to the donor-taxpayer's control. Second, all gifts involve a reduction in the donor's net assets even when taken as a deduction in determining taxable income. Thus, at the present 70% rate on ordinary income and 25% rate on long term capital gains, a gift involves a 70% direct credit against taxes and a minimum of 5% to a maximum of 30% reduction in the donor's net assets if both cash and appreciated securities are given. Under present law, where it is possible to avoid capital gains tax entirely by holding appreciated securities until death, the reduction in the donor's assets for a gift of appreciated securities is likely to be the full 30%. There is simply no way that I know of that a taxpayer can improve his overall financial position by giving to charity.

But this is not the only question involved. There is also the question of fair shares. I firmly believe that all citizens who can do so, should make a fair contribution to the cost of government. So I strongly favor putting an end to the privilege of unlimited charitable deduction, and I also favor the principle of the Limit on Tax Preferences. By measures such as these, we can make certain that all citizens pay a fair share of the cost of government without any major damage to the interests of charitable organizations.

Now a word as to why the provision for the allocation of deductions will have such serious effects on privately financed non-profit institutions. It is a well known fact that, with the exception of churches and a few institutions that rely on numerous small gifts, all large-scale, charitable money raising ventures must obtain at least 70% and often up to 80% of their funds from large givers. It is also a fact that some 70% of the total funds raised by our larger charitable institutions are in the form of gifts of appreciated securities. Clearly anything that shuts off this source of funds from non-profit institutions merits the title of Death Sentence which I have applied to the provision for the allocation of charitable deductions.

In order to illustrate the impact of this provision on large givers I asked a leading auditing firm, Price Waterhouse & Co. to prepare a model tax return for me. In preparing the model I asked them to choose a round figure of adjusted gross income and then to divide the income in the model in accordance with my own tax return. This means that the tax impact on me of H. R. 13270 is exactly the same as that shown in the model. I fully realize that each individual taxpayer would have a different situation, but I feel that the results shown in the case of the model taxpayer would be essentially similar for the great majority of large scale givers to charity. There is attached to this statement a letter from Price Waterhouse & Co. with annexes giving detailed figures and explanations of the working of the model. I will allude here only to the major results of applying the provisions of H. R. 13270 to the model tax return.

First of all, under the provisions of H. R. 13270, the model shows approximately 39% of total income in the form of so-called tax preference income. Of this total 27.3% is tax free interest from holdings of municipal securities, 30.9% is long-term capital gains excluded from income, and 39.3% represents the appreciation of securities given to charitable institutions -- none of which were private foundations. The

remaining 2.5% represents minor amounts of other tax preference income. If it were not for gifts to charity, total so-called tax preference income would be reduced to 27.7% of total income.

The overall effect of the bill on the model taxpayer would be to increase taxes by 24.2% over present law, provided he continued to make charitable contributions as in the past. Of this increase 88.8% represents the impact of the allocation of charitable deductions together with the classification of appreciation on gifts to charity as tax preference income. The model shows the full 30% of adjusted gross income permitted under the code going to charity. Larger gifts are made in appreciated securities; and make up 85% of the total. Smaller gifts are made in cash and make up the remaining 15% of charitable contributions. The model shows that, under the allocation of deductions provision, 40.1% of charitable gifts would no longer be deductible. At the 65% top rate of income tax provided for 1972, and with only 59.9% of each dollar given being deductible, less than 39% of charitable giving would be a direct tax reduction compared to 70% today. In other words, after taking account of the potential capital gains tax not presently due on securities contributed to charity, the cost of making a gift will be increased for the model taxpayer from 8.8% to 48.4%, that is, the cost of each gift will be over five times what it is now.

When I realized the heavy impact of this provision I asked Price Waterhouse & Co. how much contributions would have to be reduced under this bill to leave the taxpayer in an identical financial position to that under present law with 30% of adjusted gross income going to charity. The answer was even more shocking than I had imagined. To be in the same position under H. R. 13270 as at present charitable contributions in the model would have had to be reduced by over 93%.

When this answer was received I attempted to modify the result in every way possible. First I asked that the computation be reworked to eliminate everything except the net impact of the requirement to allocate charitable contributions. The answer came back. To fully offset this one provision, contributions would have to be reduced by 87%.

Let me make it clear that these computations were carried out by the accountants so as to leave the taxpayer in exactly the same position as under present law. This involves raising the funds to pay the increased taxes through the sale of securities that would otherwise have been donated to charity. This process involves the realization of additional capital gains which in turn increases taxes, thus requiring the sale of still more securities.

If the increased taxes were to be paid in cash and the taxpayer were willing to ignore a substantial increase in potential future tax liability on his unrealized capital gains as compared to present law, the required reduction in contributions would be considerably less. However, they still would have to be reduced by 40.1%. I leave it to you to imagine the impact on charitable institutions of a provision that would require a reduction of from 40% to 87% in large contributions in order to offset the effects of a Congressional decision to substantially lessen the incentives to private charitable giving.

I note that the Treasury Department in testimony before your Committee has recommended that appreciation of securities given to charity be eliminated from the classification of tax preference income as defined in H. R. 13270. I welcome this recognition of the problem. Unfortunately, however, the Treasury proposal is far too modest. Its effect would, at least in the model, be minor. The accountants have calculated that, on the basis of the Treasury proposal, there would be an overall increase in tax of 17.8% of which 84.7% would be due to the allocation of charitable contributions. Because of the complexities of the law the reduction in contributions required to fully offset this allocation of charitable gifts would be unchanged from that required by the House bill. However, if the taxpayer were willing to accept an increase in his potential tax liability on unrealized appreciation, the reduction in contributions would be 34.7% as compared to 40.1% in H. R. 13270. In other words, at the best the Treasury proposal would only eliminate 13-1/2% of the problem; at the worst it would be no help at all. This is why I must characterize it as well intentioned but wholly inadequate. What is required is nothing less than the total elimination of the allocation of deductions provisions as far as it applies to charitable deductions. It must be recognized that solely by reducing the top tax rate from 70% to 65%, the cost of charitable contributions borne by large givers will be increased to a maximum of 35% from the present 30% -- an increase of 16-2/3%. Because of the benefits from the reduction in rates, this increase in the cost of giving can safely be ignored. But it should not be forgotten.

Finally, I would like to stress what is clear in all of what I have said. Taxpayers can readily offset the burden of the allocation of charitable deductions by reducing their giving. If such legislation is enacted it would be a clear signal that the Congress considers that the national interest is less well served than in the past by the continuation of private financing for our major charitable institutions. Large givers could not fail to draw the conclusion that their giving was no longer as essential as in the past. The result would be sheer catastrophe

for our privately financed charities, and a change of epochal importance in our whole social system. When it is realized what is involved it is most difficult for me to see how the Congress can fail to strike this crippling provision from H. R. 13270. I strongly urge you to do just this.

Before I close I have two comments on other matters. First, I very much favor the Treasury proposal to reduce the tax on foundation income from 7-1/2% to 2%. This is enough to pay for an intensive policing of foundation activities. Anything more merely transfers that much of the burden of charitable activities from the private sector to the government budget.

Second, in my capacity as Chairman of the Acquisitions Committee of the Metropolitan Museum of Art in New York, I strongly urge support of the Treasury proposal to strike from H. R. 13270 the provisions which would disallow all appreciation on works of art given to museums. When I served in the Treasury I was instrumental in starting the process which lead to the creation of a special advisory group of art experts to advise the Internal Revenue Service on problems arising in this area. As Assistant Secretary Cohen has stated, this Advisory Group, along with improved audit programs, has substantially eliminated the problems that once existed in this area. Therefore, there is now no need to kill the goose that lays the golden eggs as would certainly be the case for all museums if the provisions of H. R. 13270 on donations of works of art were allowed to stand.

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C. DOUGLAS DILLON

EFFECT OF PROPOSED TAX CHANGES
ON CHARITABLE GIVING

* * * * *

SEPTEMBER 18, 1969

PRICE WATERHOUSE & CO.

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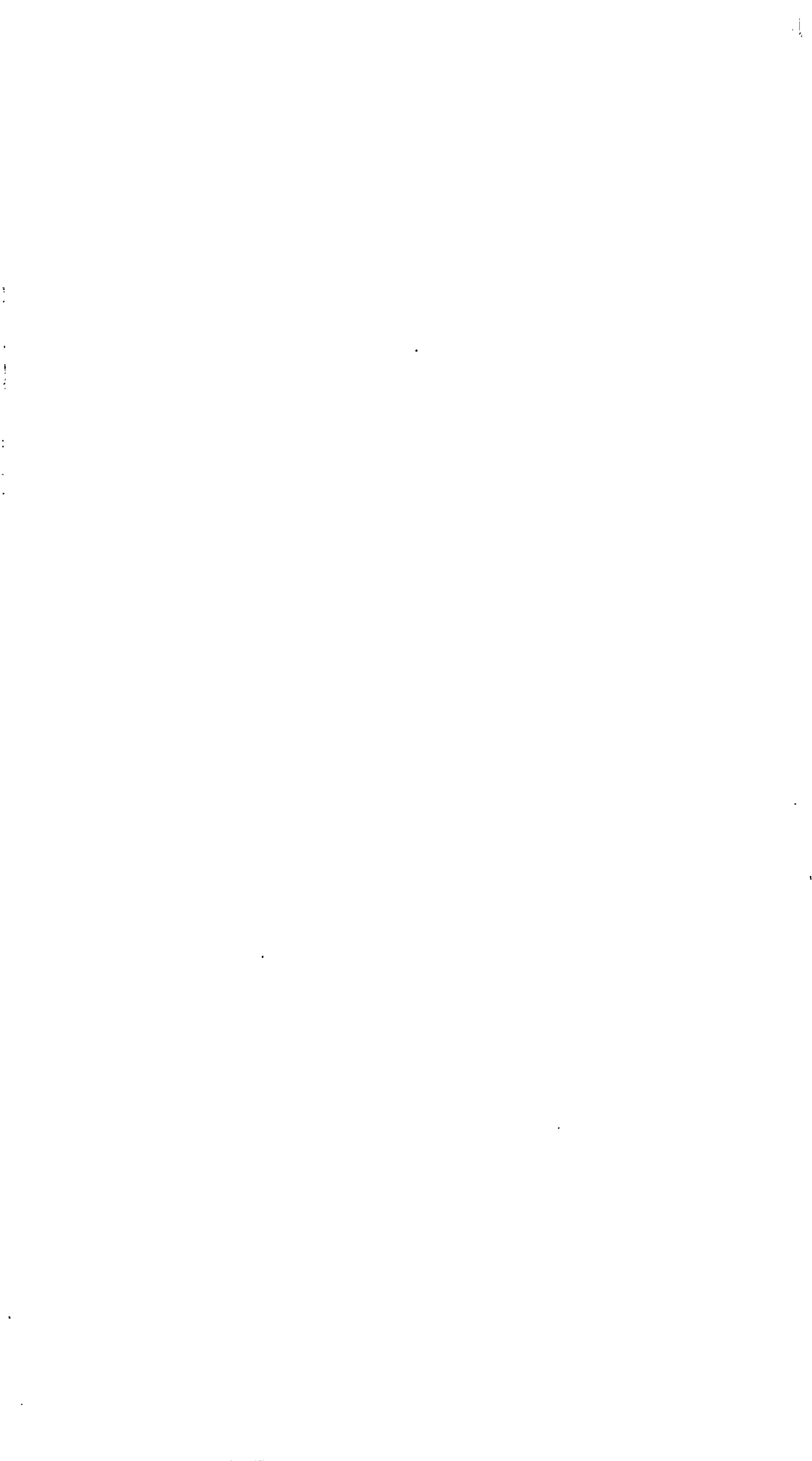

PRICE WATERHOUSE & CO.

60 BROAD STREET

NEW YORK 10004

September 18, 1969

The Honorable C. Douglas Dillon
767 Fifth Avenue
New York, New York 10022

Dear Sir:

EFFECT OF PROPOSED TAX CHANGES
ON CHARITABLE GIVING

As you requested, we have analyzed the provisions of the proposed Tax Reform Bill of 1969, as passed by the House of Representatives and hereinafter referred to as H.R. 13270, as they would apply to the taxpayer in the accompanying "Taxpayer Model" which we understand is patterned after your own case but in which actual amounts have been proportionately disguised. Based on this analysis we have determined the effect of:

I. H.R. 13270 and
II. H.R. 13270, modified only by the Administration's proposal to eliminate long-term appreciation on contributed property from tax preference income

on the amount of charitable giving if the taxpayer desired to remain in essentially the same economic position, after taxes and charitable contributions, as he would be in under present tax rules. There are other provisions in the Administration's proposal which have been ignored for this model taxpayer.

On the basis of the information and assumptions stated in the "Taxpayer Model" accompanying this report, we have determined that:

I. Federal income tax would increase by $90,000. (i.e., from $371,600. to $461,600.) as the result of H.R. 13270 if charitable contributions were not altered in response to the proposed changes.

II. Federal income tax would increase by $66,000. (i.e., from $371,600. to $437,600.) as the result of H.R. 13270, modified by the Administration's proposal, if charitable contributions were not altered in response to the proposed changes.

III. Charitable contributions would be reduced from $300,000. to $20,900., a reduction of $279,100., were the taxpayer to pay the tax increase imposed on him by H.R. 13270 by reducing his gifts of appreciated securities to charitable organizations and, instead, selling sufficient amounts of them to provide funds for such payment. Our calculations show on this basis that this taxpayer could give no appreciated securities to charities, and, in fact, would have to also reduce cash gifts. The identical result is also reached under H.R. 13270, modified by the Administration's proposal, due to the differing effect of the allocation of deductions fraction in this instance relative to the H.R. 13270 case alone.

Also included for your information in the accompanying "Taxpayer Model" is, in our opinion, a complete analysis of the proposed tax law changes in comparison with the present tax rules.

Yours very truly,

Price Waterhouse & Co.

TAXPAYER MODEL

GENERAL

Under the present Internal Revenue Code, a married taxpayer has both taxable and tax exempt income. The taxpayer who is in the highest tax bracket normally follows the practice of making charitable contributions to the extent allowable as a deduction for Federal Income Tax purposes.

Being informed of H.R. 13270, the taxpayer realizes that the provisions of H.R. 13270 will result in an increase in tax when such tax is calculated on the same income and deductions under both the present and proposed laws.

Since the tax increase is substantially attributable to the required allocation of charitable contributions and the inclusion of long term appreciation on securities donated to charity in tax preference income, the taxpayer is interested in knowing by what amount he must reduce charitable giving to enable him to maintain the same after-tax financial position.

The taxpayer is also interested in knowing the effect of the Administration's proposal solely with respect to the elimination of long term appreciation on contributed property from tax preference income with respect to the above mentioned contribution reduction.

MAINTENANCE OF AFTER-TAX FINANCIAL POSITION

To pay the increased Federal Income Tax through the reduction of contributions, the taxpayer must determine the point where the funds provided by a reduction in contributions equals the increase in Federal Income Tax:

1. As computed under H.R. 13270 over the Federal Income Tax, which he would expect to pay, as computed under the present Internal Revenue Code

2. or as computed under H.R. 13270, modified by the Administration's proposal as explained above, over the Federal Income Tax, which he would expect to pay, as computed under the present Internal Revenue Code.

CRITERIA

To develop the formula required to mathematically calculate the payment of the increased Federal Income Taxes noted above, it was necessary to satisfy certain criteria. They are:

1. The maximum amount of desired contributions to be made.
2. The type of recipients of such contributions.
3. The form (cash and/or appreciated property) which the contributions will take.
4. If appreciated property is to be given, the character of the gain which would be realized had the taxpayer instead sold the property.
5. Precisely estimated amounts for all elements of income and expense which have a tax consequence.

ASSUMPTIONS

The above criteria were satisfied by the following assumptions which apply to the taxpayer:

1. The desired maximum amount of contributions to be made by the the taxpayer is $300,000. This amount corresponds to 30% of adjusted gross income as calculated under the present Internal Revenue Code and is consistent with the taxpayer's charitable giving practices as established in prior years.

2. The recipients of the gifts will be publicly supported charities which are eligible for the 30% deduction under the present Internal Revenue Code and the 50% deduction under proposed H.R. 13270.

3. The charitable contributions will be in the form of cash and appreciated securities. Since many organizations promote a cause which is worthy of some recognition, the taxpayer wants to make small grants of cash to them. Other organization are more favored for various reasons and, therefore, large gifts of appreciated securities will be made. The security contributions will be reduced before the cash contributions. Of the $300,000. total desired contributions, the taxpayer expects to make $45,600. in cash and the balance of $254,400. in appreciated securities.

4. The securities donated will be securities which, if sold, would constitute a long term capital transaction. Since the taxpayer's cost basis in the securities to be given is negligible, it is assumed for this model that such securities have no tax basis.

5. The estimated income and expense data, furnished by the taxpayer and detailed on Schedule A, are considered sufficiently accurate estimates on an annual basis.

   (a) Except for the level of contributions which is adjusted appropriately in response to the effect of the proposed changes in tax liability and the tax liability itself, all of these other income and deductions are considered to remain constant in amount and composition between a year under present rules and a year under proposed rules.

   (b) Certain "transitional" rules contained in H.R. 13270 have ceased to be applicable, and all of its provisions are considered fully in force for the purpose of the tax computations. This affects primarily the treatment of interest on municipal obligations. It is further assumed that all of these bonds owned by the taxpayer were issued after July 11, 1969 and that municipalities have not elected to issue taxable obligations.

   (c) The present and proposed tax surcharge is ignored since it is considered a transitory feature.

   (d) No effect is given to the changes in any state and local income taxes paid by the taxpayer which are attributable to the proposed federal changes.

INCREASE IN FEDERAL INCOME TAX

Based on the above assumptions, it was possible to compute the Federal Income Tax under the present Internal Revenue Code. This, then, is the amount of tax the taxpayer would expect to pay in the taxable year notwithstanding any revisions in the tax laws. This amount too, then, must remain constant in calculating the point where funds provided through reduction in contributions equal the increase in the tax computed on the proposed bases over the tax computed on the present Code.

The computations of the Federal Income Tax at the maximum desired contribution level of $300,000. with $45,600. in cash and $254,400. in appreciated securities, zero tax basis, and detailed analyses of the effects of the proposals on such tax as compared with the present tax appear on Schedules B through B-7.

REDUCTION IN CONTRIBUTIONS

The reduction in contributions was calculated on the basis of the assumption that the securities, withheld from charity, were sold to provide money to pay Federal Income Tax in order to allow the taxpayer to remain in the exact same economic position, after taxes and charitable contributions. The validity of this assumption and the substantiation of the resulting reduced contribution level is illustrated in Schedules C through C-4.

The calculation of the charitable contributions which the taxpayer could still make to produce the desired reduction in contributions and corresponding payment of tax required the use of a complicated mathematical formula since the sale of securities to produce cash, in itself, incurs additional direct tax and, further, affects the allowability of the remaining charitable contribution and other allocable deductions under the proposed rules.

The application of this mathematical formula, programmed for computer applications, produced the following applicable to both H.R. 13270 and H.R. 13270 Modified By Administration's Proposal:

	Total desired contribution	Required reduction	Balance for contribution	Percentage reduction
Cash	$ 45,600.	$ 24,702.	$20,898.	
Appreciated securities	254,400.	254,400.	-	
Total	$300,000.	$279,102.	$20,898.	93.03%

COMPUTATION OF REDUCED CONTRIBUTION LEVEL

Schedule D shows the computer program used to calculate the required contribution reduction and other supplemental information. This program was developed from formulae, which have been reviewed and found reasonable, provided by the taxpayer. It is understood that this program is primarily applicable to this particular taxpayer since it incorporates the various provisions of the proposed laws only as they apply to such taxpayer.

However, it illustrates the fact that any particular taxpayer could have his own situation analyzed and formulated to quickly determine the effects of his charitable giving upon his Federal Income Tax even though the proposed provisions are extremely complicated.

Schedule D-1 illustrates the result of applying the computer program in this taxpayer's situation.

OTHER ASSUMPTIONS WITH RESPECT TO CONTRIBUTION REDUCTION

Schedule E sets forth the required contribution reductions should the taxpayer avail himself of other alternatives available to him in reducing his contributions to offset increased tax.

TAXPAYER MODEL

DETAILS OF INCOME, DEDUCTIONS, AND OTHER FACTORS WHICH ARE ASSUMED TO REMAIN CONSTANT (AS FURNISHED BY TAXPAYER)

I.	Income items		
	Salary	$ 12,800.	
	Ordinary dividends (after exclusions)	822,000.	
	Other interest	600.	
	Partnerships, trusts and small business corporations	(45,900.)	
	Business income	10,500.	
	Total ordinary income		$800,000.
	Fifty percent of total long term capital gain		200,000.
II.	Nonallocable deduction items		
	Nonallocable deductions		45,800.
	Personal exemptions (husband and wife)		1,200.
III.	Allocable deduction items		
	Taxes and noninvestment interest		23,600.
IV.	Tax preference items		
	A - For limit on tax preference		
	Excess of accelerated over straight line depreciation		1,800.
	Fifty percent of total long term capital gain excluded from income		200,000.
	Net "Tax Exempt" municipal bond interest		176,400.
	B - Additional items for allocation of deductions		
	Excess of intangible drilling and development costs over deductions allowable if capitalized		14,600.
	Statutory allowance		(10,000.)

COMPUTATION OF FEDERAL INCOME TAX
AT MAXIMUM DESIRED ($300,000) CONTRIBUTION LEVEL

	Present Internal Revenue Code		H. R. 13270*		H. R. 13270 modified by administration's proposal**	
INCOME						
Ordinary income	$ 800,000.		$ 800,000.		$ 800,000.	
Fifty percent of total long-term capital gain	200,000.		200,000.		200,000.	
Adjusted gross income computed without regard to disallowed tax preference provision	1,000,000.		1,000,000.		1,000,000.	
Disallowed tax preferences from Schedule B1	Not applicable		None		None	
Adjusted gross income		$1,000,000.		$1,000,000.		$1,000,000.
Itemized deductions						
Allocable:						
Contributions	300,000.		300,000.		300,000.	
Other	23,600.		23,600.		23,600.	
Total allocable	Not applicable		323,600.		323,600.	
Nonallocable	45,800.		45,800.		45,800.	
Total itemized deductions		(369,400.)		(369,400.)		(369,400.)
		630,600.		630,600.		630,600.
Exemptions		(1,200.)		(1,200.)		(1,200.)
Taxable income without allocation		629,400.		629,400.		629,400.
Disallowed allocable deductions		Not applicable		129,667.		92,744.
Taxable income		629,400.		759,067.		722,144.
Fifty percent of total long-term capital gain		(200,000.)		Not applicable		Not applicable
Ordinary taxable income		$ 429,400.		$ 759,067.		$ 722,144.
Tax per married taxpayers filing joint return						
Rate table on ordinary taxable income						
$110,980. plus 70% of excess over $200,000.		$271,560.		Not applicable		Not applicable
$228,180. plus 65% of excess over $400,000.		Not applicable		$ 461,574.		$ 437,574.
Fifty percent of 50% of long-term capital gain		100,000.		Not applicable		Not applicable
Total tax liability (without tax surcharge)		$ 371,560.		$ 461,574.		$ 437,574.
Increase over tax prepared on basis of present internal revenue code				$ 90,014.		$ 66,014.
Percentage increase over tax prepared on basis of present internal revenue code				24.23%		17.77%

* The computations under H. R. 13270 assume that all provisions are fully effective and that municipalities have not elected to issue taxable bonds.

** The computations under H. R. 13270 modified by administration's proposal are identical to those under H. R. 13270 _except_ that long-term appreciation on securities given to charity are _not_ included in "Items of Tax Preference."

TAXPAYER MODEL

COMPUTATION OF DISALLOWED TAX PREFERENCES AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	H.R.13270	H.R.13270 modified by administration's proposal
Items of tax preference		
Long term appreciation on securities donated to publicly supported charities	$ 254,400.	Not applicable
Excess of accelerated depreciation over straight line depreciation	1,800.	$ 1,800.
Fifty percent of total long term capital gain excluded from income	200,000.	200,000.
Net municipal bond interest	176,400.	176,400.
Total tax preferences	632,600.	378,200.
Adjusted gross income computed without regard to disallowed tax preference provision from Schedule B	1,000,000.	1,000,000.
Total	$1,632,600.	$1,378,200.
Limit on tax preferences - greater of $10,000. or 50% of above total	$ 816,300.	$ 689,100.
Disallowed tax preferences		
Excess of total tax preferences	$ 632,600.	$ 378,200.
Over limit on tax preferences	816,300.	689,100.
Which is	None	None

TAXPAYER MODEL

CONTRIBUTIONS AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	Present Internal Revenue Code	H.R.13270	H.R.13270 modified by administration's proposal
Contribution base			
Adjusted gross income from Schedule B.	$1,000,000.	$1,000,000.	$1,000,000.
Allowable tax preferences from Schedule B1		632,600.	378,200.
Excess of intangible drilling and development costs over alternative of capitalizing such costs and using straight line depreciation		14,600.	14,600.
Statutory deduction		(10,000.)	(10,000.)
Total tax preferences as defined for this section and for allocation of deductions		637,200.	382,800.
Contribution base	$1,000,000.	$1,637,200.	$1,382,800.
Limitations on contributions deduction			
Publicly supported charities:			
At 30% of contribution base	$ 300,000.		
At 50% of contribution base		$ 818,600.	$ 691,400.
At 30% of contribution base on gifts of appreciated securities which, if sold, would result in long term capital gain		$ 491,160.	$ 414,840.
Contributions to publicly supported charitable organizations			
Appreciated securities which, if sold, would result in long term capital gain	$ 254,400.	$ 254,400.	$ 254,400.
Cash	45,600.	45,600.	45,600.
Total contributions	$ 300,000.	$ 300,000.	$ 300,000.

TAXPAYER MODEL

ALLOCATION OF DEDUCTIONS AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	H.R.13270	H.R.13270 modified by administration's proposal
Computation of "Section 277 Fraction" (Disallowance Factor)		
Allowable tax preferences as defined for this provision (ATP) from Schedule B2	$ 637,200.	$ 382,800.
Modified adjusted gross income:		
Taxable income determined without regard to this provision from Schedule B	629,400.	629,400.
Allocable deductions from Schedule B	323,600.	323,600.
Total modified adjusted gross income (MAGI)	953,000.	953,000.
Total ATP and MAGI	$1,590,200.	$1,335,800.
ATP / (ATP + MAGI) =	.4007	.2866
Computation of disallowed deductions		
The lesser of allowable tax preferences	$ 637,200.	$ 382,800.
or the		
Allocable deductions of $323,600. multiplied by the "Section 277 Fraction"	$ 129,667.	$ 92,744.

Analysis of disallowed deductions - H.R.13270

	Gross allocable deductions: Percent of total	Amount	Amount disallowed
Contributions	92.707%	$300,000.	$120,210.
Other	7.293%	23,600.	9,457.
	100.000%	$323,600.	$129,667.

Contributions disallowed as a percent of total contributions - 40.07%

Analysis of disallowed deductions - H.R.13270 modified by administration's proposal

	Gross allocable deductions: Percent of total	Amount	Amount disallowed
Contributions	92.707%	$300,000.	$85,980.
Other	7.293%	23,600.	6,764.
	100.000%	$323,600.	$92,744.

Contributions disallowed as a percent of total contributions - 28.66%

TAXPAYER MODEL

ANALYSIS OF INCREASE IN
FEDERAL INCOME TAX H.R.13270
AT MAXIMUM DESIRED ($300,000.)
CONTRIBUTION LEVEL

	Increase (Decrease)	
	Amount	Percent
Federal income tax computed under H.R.13270 from Schedule B	$461,574.	
Federal income tax computed under present Internal Revenue Code from Schedule B	371,560.	
Total increase	$ 90,014.	24.23%*
Analysis of increase ***		
Allocation of deductions between taxable and tax preference income:		
Cash contributions at base "Section 277 Fraction" ($13,069. at 70%)	$ 9,148.	10.163%
Appreciated security contributions at base "Section 277 Fraction" ($72,911. at 70%)	51,038.	56.700
	60,186.**	66.863%
Additional disallowance of cash contributions by reason of giving appreciated securities ($5,203. at 70%)	3,642.	4.046%
Disallowance of appreciated security contributions from base "Section 277 Fraction" to actual "Section 277 Fraction" ($29,027. at 70%)	20,319.	22.573
	23,961.	26.619%
Other allocable deductions at base "Section 277 Fraction" ($6,764. at 70%)	4,735.**	5.260%
Additional disallowance of other allocable deductions by reason of giving appreciated securities ($2,693 at 70%)	1,885.	2.094%
Elimination of alternative capital gains tax rate ($200,000. at 20%)	40,000.	44.438%
Reduction in individual tax rate schedules:		
Without regard to other proposed changes (on ordinary taxable income of $429,400.)	(24,270.)**	(26.962%)
Coupled with:		
Elimination of alternative capital gains tax rate ($200,000. at 5%)	(10,000.)**	(11.109%)
Allocation of deductions:		
Cash contributions at base "Section 277 Fraction" ($13,069. at 5%)	(653.)	(0.726%)
Appreciated security contributions at base "Section 277 Fraction" ($72,911. at 5%)	(3,646.)	(4.050)
	(4,299.)**	(4.776%)

	Increase (Decrease)	
	Amount	Percent
Allocation of deductions (cont'd):		
Additional disallowance of cash contributions by reason of giving appreciated securities ($5,203. at 5%)	(260.)	(0.289%)
Disallowance of appreciated security contributions from base "Section 277 Fraction" to actual "Section 277 Fraction" ($29,027. at 5%)	(1,451.)	(1.612%)
	(1,711.)	(1.901%)
Other allocable deductions at base "Section 277 Fraction" ($6,764. at 5%)	(338.)**	(0.376%)
Additional disallowance of other allocable deductions by reason of giving appreciated securities ($2,693. at 5%)	(135.)	(0.150%)
Totals	$ 90,014.	100.000%

* The net increase in tax resulting from the requirement to allocate contributions between taxable and tax preference and to include appreciation on securities given to charity in tax preference income is $79,887. Of the total increase in tax, this represents 88.75%. The increase over the present tax with respect to the aforementioned provisions alone is 23.15% and together with the rate reduction is 21.50%.

** The total of these items equals the increase in tax under H.R. 13270 modified by administration's proposal. In addition each individual subtotal may be agreed to their equivalent increases under each proposal on Schedule B5.

*** In this analysis, the phrase "base 'Section 277 Fraction" refers to the disallowance factor at zero level of contributions; as cash is given to charities, this value remains constant. The phrases "Disallowance .... from base 'Section 277 Fraction' to actual 'Section 277 Fraction" or the "additional disallowance... by reason of giving appreciated securities" means the additional disallowance of allocable expenditures resulting from an increase in the disallowance factor at zero (or cash) contributions to the disallowance factor at the $300,000. contribution level which results from giving $254,400., zero tax basis, of appreciated securities in this model.

TAXPAYER MODEL

ANALYSIS OF INCREASE IN FEDERAL INCOME TAX H.R.13270 MODIFIED BY ADMINISTRATION'S PROPOSAL AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	Increase (Decrease)	
	Amount	Percent
Federal income tax computed under H.R.13270 modified by administration's proposal from Schedule B	$437,574.	
Federal income tax computed under present Internal Revenue Code from Schedule B	371,560.	
Total increase	$ 66,014.	17.77% (*)
Analysis of increase **		
Allocation of deductions between taxable and tax preference income:		
Contributions at base "Section 277 Fraction" ($85,980. at 70%)	$ 60,186.	91.172%
Other base "Section 277 Fraction" ($6,764. at 70%)	4,735.	7.172
Elimination of alternative capital gains tax rate ($200,000. at 20%)	40,000.	60.593
Reduction in individual tax rate schedules: Without regard to other proposed changes (on ordinary taxable income of $429,400.)	(24,270.)	(36.765)
Coupled with:		
Elimination of alternative capital gains tax rate ($200,000. at 5%)	(10,000.)	(15.148)
Allocation of deductions:		
Contributions at base "Section 277 Fraction" ($85,980. at 5%)	(4,299.)	(6.512)
Other at base "Section 277 Fraction" ($6,764. at 5%)	(338.)	(0.512)
Totals	$ 66,014.	100.000%

(*) The net increase in tax resulting from the requirement to allocate contributions between taxable and tax preference income is $55,887. Of the total increase in tax, this represents 84.659%. The increase over the present tax with respect to the allocation of contributions alone is 16.198% and together with the rate reduction is 15.041%.

** The term "base Section 277 Fraction" referes to the disallowance factor at zero contributions. Under this proposal, such factor remains constant at all levels of contributions regardless of form.

33-758 O - 69 - No. 11 -- 2

TAXPAYER MODEL

ANALYSIS OF INCOME AT MAXIMUM DESIRED ($300,000) CONTRIBUTION LEVEL

	As defined by: H. R. 13270			H. R. 13270 modified by administration's proposal		
	Amount	Percent of total income	Percent of total tax preference income	Amount	Percent of total income	Percent of total tax preference income
Adjusted gross taxable income from Schedule B	$1,000,000.	61.08%	-	$1,000,000.	72.32%	-
Tax preference income (for allocation of itemized deductions)						
Long-term appreciation on securities donated to publicly supported charities	254,400.	15.54%	39.93%	-	-	-
Fifty percent of total long-term capital gain excluded from income	200,000.	12.22	31.39	200,000.	14.46	52.25
Net municipal bond interest	176,400.	10.77	27.68	176,400.	12.75	46.08
Excess of intangible drilling and development costs over alternative of capitalizing such costs and using straight-line depreciation	14,600.	0.89	2.29	14,600.	1.06	3.81
Excess of accelerated depreciation over straight-line depreciation	1,800.	0.11	0.28	1,800.	0.13	0.47
Statutory deduction	(10,000.)	(0.61)	(1.57)	(10,000.)	(0.72)	(2.61)
Total tax preference income, as defined	637,200.	38.92%	100.00%	382,800.	27.68%	100.00%
Total income	$1,637,200.	100.00%		$1,382,800.	100.00%	
Total tax preference income	$ 637,200.					
Less long-term appreciation on securities donated to publicly supported charities	254,400.					
Total tax preference income without appreciation on charitable gifts	382,800.	27.68%				
Adjusted gross taxable income	1,000,000.	72.32				
	$1,382,800.	100.00%				

COST OF GIVING COMPARISON
AT MAXIMUM DESIRED ($300,000) CONTRIBUTION LEVEL

Present Internal Revenue Code

Form of gift	Total gift	Direct reduction in federal income tax at 70%	Capital gains tax saved at 25%	Net cost	Net cost as a percentage of total gift
Cash	$ 45,600	($ 31,920.)	-	$13,680.	30.000%
Appreciated securities	254,400.	(178,080.)	($63,600.)	12,720.	5.000%
Total	$300,000.	($210,000.)	($63,600.)	$26,400.	8.800%

H. R. 13270

Form of gift	Total gift	Direct reduction in federal income tax at 65%	Capital gains tax saved at 32-1/2%	Disallowances by operation of "Section 277 Fraction": Cash contribution only at .2866*	Appreciated security contribution only at .4007**	Add'l. cash contribution at .1141***	Add'l. other deductions of $23,600. at .1141***	Net cost	Net cost as a percentage of total gift
Cash	$ 45,600.	($ 29,640.)	-	$13,069.	-	-	-	$ 29,029.	63.660%
Appreciated securities	254,400	(165,360.)	($82,680.)	-	$101,938.	$5,203.	$2,693.	116,194.	45.6[illegible]
Total	$300,000.	($195,000.)	($82,680.)	$13,069.	$101,938.	$5,203.	$2,693.	$145,223.	48.408%

	Present Internal Revenue Code	H. R. 13270	Increase	Percentage increase
Net cost as a percentage of total gift	8.800%	48.408%	39.608%	450.09%

H. R. 13270 modified by administration's proposal

Form of gift	Total gift	Direct reduction in federal income tax at 65%	Capital gains tax saved at 32-1/2%	Disallowance by operation of "Section 277 Fraction" - Contributions at .2866*	Net cost	Net cost as a percentage of total gift
Cash	$ 45,600.	($ 29,640.)	-	$13,069	$ 29,029.	63.660%
Appreciated securities	254,400.	(165,360.)	($82,680.)	72,911.	79,271.	31.160
Total	$300,000	($195,000.)	($82,680.)	$85,980	$108,300.	36.100%

	Present Internal Revenue Code	H. R. 13270 modified by administration's proposal	Increase	Percentage increase
Net cost as a percentage of total gift	8.800%	36.100%	27.300%	310.227%

*Base "Section 277 Fraction" (Disallowance Factor at zero level of contributions) - In H. R. 13270 modified by administration's proposal, this remains constant at all levels of contributions regardless of form.

**"Section 277 Fraction" at $300,000. level of contributions.

***Difference between above "Section 277 Fraction" values.

SCHEDULE C

TAXPAYER MODEL

PROOF OF REDUCED CONTRIBUTION TO $20,898

	Present code		H. R. 13270		H. R. 13270 modified by administration's proposal	
	Account					
	Cash	Security	Cash	Security	Cash	Security
Balance - beginning of year at market	-	$254,400.	-	$254,400.	-	$254,400.
Transactions during year						
Adjusted gross income	$1,000,000.		$1,127,200.	($127,200.)	$1,127,200.	($127,200.)
Municipal bond interest	176,400.		176,400.		176,400.	
50% long-term capital gain excluded from income	200,000.		327,200.	(127,200.)	327,200.	(127,200.)
Totals	$1,376,400.	$254,400.	$1,630,800.	($254,400.)	$1,630,800.	($254,400.)
Contributions	($ 45,600.)	($254,400.)	($ 20,898.)		($ 20,898.)	
Nonallocable deductions	(45,800.)		(45,800.)		(45,800.)	
Base allocable deduction:	(23,600.)		(23,600.)		(23,600.)	
Federal income tax	(371,560.)		(650,662.)		(650,662.)	
Totals	($ 486,560.)	($254,400.)	($ 740,960.)	-	($ 740,960.)	-
Balance - end of year	$ 889,840.	$ -	$ 889,840.	$ -	$ 889,840.	$ -

SCHEDULE C1

TAXPAYER MODEL

COMPUTATION OF FEDERAL INCOME TAX
AT REDUCED CONTRIBUTION LEVEL OF $20,898

	H. R. 13270		H. R. 13270 modified by administration's proposal	
INCOME				
Ordinary income	$ 800,000.		$ 800,000.	
Fifty percent of long-term capital gain:				
Original amount	200,000.		200,000.	
On sale of securities previously given to charity	127,200.		127,200.	
Adjusted gross income computed without regard to disallowed tax preference provision	$1,127,200.		$1,127,200.	
Disallowed tax preferences	None		None	
Adjusted gross income		$1,127,200.		$1,127,200.
Itemized deductions				
Allocable:				
Contributions	$ 20,898.		$ 20,898.	
Other	23,600.		23,600.	
Total allocable	$ 44,498.		$ 44,498.	
Nonallocable	45,800.		45,800.	
Total itemized deductions		(90,298.)		(90,298.)
		$1,036,902.		$1,036,902.
Exemptions		(1,200.)		(1,200.)
Taxable income without allocation		$1,035,702.		$1,035,702.
Disallowed allocable deductions		14,270.		14,270.
Taxable income		$1,049,972.		$1,049,972.
Tax per married taxpayers filing joint return rate table on ordinary taxable income				
$228,180. plus 65% of excess over $400,000.		$ 650,662.		$ 650,662.

TAXPAYER MODEL

COMPUTATION OF DISALLOWED TAX PREFERENCES AT REDUCED CONTRIBUTION LEVEL OF $20,898

	H.R.13270	H.R.13270 modified by administration's proposal
Items of tax preference		
Excess of accelerated depreciation over straight line depreciation	$ 1,800.	$ 1,800.
Fifty percent of total long term capital gain excluded from income:		
Original amount	200,000.	200,000.
On sale of securities previously given to charity	127,200.	127,200.
Net municipal bond interest	176,400.	176,400.
Total tax preferences	505,400.	505,400.
Adjusted gross income computed without regard to disallowed tax preference provision	1,127,200.	1,127,200.
Total	$1,632,600.	$1,632,600.
Limit on tax preferences - greater of $10,000. or 50% of above total	$ 816,300.	$ 816,300.
Disallowed tax preferences		
Excess of total tax preferences	$ 505,400.	$ 505,400.
Over limit on tax preferences	816,300.	816,300.
Which is	None	None

TAXPAYER MODEL

CONTRIBUTIONS AT REDUCED CONTRIBUTION LEVEL OF $20,898.

	H.R.13270	H.R.13270 modified by administration's proposal
Contribution base		
Adjusted gross income	$1,127,200.	$1,127,200.
Allowable tax preferences	505,400.	505,400.
Excess of intangible drilling and development costs over alternative of capitalizing such costs and using straight line depreciation	14,600.	14,600.
Statutory deduction	(10,000.)	(10,000.)
Total tax preferences as defined for this section and for allocation of deductions	510,000.	510,000.
Contribution base	$1,637,200.	$1,637,200.
Limitations on contributions deduction		
Publicly supported charities:		
At 50% of contribution base	$ 818,600.	$ 818,600.
At 30% of contribution base on gifts of appreciated securities which, if sold, would result in long term capital gain	$ 491,160.	$ 491,160.

TAXPAYER MODEL

ALLOCATION OF DEDUCTIONS AT REDUCED CONTRIBUTION LEVEL OF $20,898.

	H.R.13270	H.R.13270 modified by administration's proposal
Computation of "Section 277 fraction"		
Allowable tax preferences as defined for this section (ATP)	$ 510,000.	$ 510,000.
Modified adjusted gross income:		
Taxable income determined without regard to this provision	1,035,703.	1,035,703.
Allocable deductions	44,498.	44,498.
Total modified adjusted gross income (MAGI)	1,080,201.	1,080,201.
Total ATP and MAGI	$1,590,201.	$1,590,201.
$\frac{\text{ATP}}{\text{ATP + MAGI}}$	.3207	.3207
Computation of disallowed deductions		
The lesser of allowable tax preferences	$ 510,000.	$ 510,000.
or the		
Allocable deductions of $44,497. multiplied by the "Section 277 fraction"	$ 14,270.	$ 14,270.

```
LOAD HR13270
READY

LIST

HR13270     16:14   09/15/69  MONDAY     NYC

10 PRINT "THIS PROGRAM COMPUTES THE VALUE OF THE 'CRITICAL CHARITABLE"
20 PRINT "CONTRIBUTION' WHICH CAUSES THE DECREASE IN CHARITABLE CON-"
30 PRINT "TRIBUTIONS TO EQUAL THE INCREASE IN TAXES WHEN THE PROVISIONS"
40 PRINT "OF H.R. 13270 ARE APPLIED AND COMPARED WITH THE RESULTS"
50 PRINT "DERIVED FROM THE PRESENT TAX LAW."
60 PRINT
70 PRINT
80 PRINT "ENTER MAXIMUM CASH CONTRIBUTION X1";
90 INPUT X1
100 PRINT "ENTER MAXIMUM TOTAL CONTRIBUTION X2";
110 INPUT X2
120 PRINT "ENTER TAX UNDER EXISTING LEGISLATION";
130 INPUT T0
140 PRINT
150 PRINT "OPTIONS:"
160 PRINT
170 PRINT "   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'";
180 INPUT N$
190 IF N$='YES' GO TO 230
200 IF N$='NO' GO TO 250
210 PRINT "ERROR!  RETYPE ANSWER YES OR NO."
220 GO TO 160
230 LET N=1
240 GO TO 260
250 LET N=0
260 PRINT "   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO"
270 PRINT "      CONTRIBUTIONS";
280 INPUT E$
290 IF E$='YES' GO TO 330
300 IF E$='NO' GO TO 350
310 PRINT "ERROR!  RETYPE ANSWER YES OR NO."
320 GO TO 280
330 LET E=1
340 GO TO 360
350 LET E=0
360 PRINT "   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL";
370 INPUT C$
380 IF C$='YES' GO TO 420
390 IF C$='NO' GO TO 440
400 PRINT "ERROR!  RETYPE ANSWER YES OR NO."
410 GO TO 370
420 LET C=1
430 GO TO 450
440 LET C=0
450 PRINT
460 PRINT
470 LET X=X1
480 GOSUB 780
490 LET F1=F
500 LET X=X2
510 GOSUB 780
520 LET F2=F
530 LET X=(X1*F2-X2*F1)/(F2-F1)
540 GOSUB 780
550 LET F0=F
560 LET X0=X
570 LET X=(X1*F0-X0*F1)/(F0-F1)
580 GOSUB 780
590 IF ABS(F)>1 GO TO 550
600 PRINT USING 610
610 :          CRITICAL
620 PRINT USING 630
630 :         CHARITABLE    TAX UNDER        TAX     CONTRIBUTION
640 PRINT USING 650
650 :        CONTRIBUTION   H.R.13270     INCREASE     DECREASE
660 PRINT
670 PRINT USING 680 ,X,T,T-T0,X2-X
680 :           #######     #######        #######     #######
690 PRINT
700 PRINT "DO YOU WISH TO CONSIDER OTHER OPTIONS";
710 INPUT O$
720 IF O$='YES' GO TO 760
730 IF O$='NO' GO TO 770
740 PRINT "ERROR!  RETYPE ANSWER YES OR NO."
750 GO TO 710
760 GO TO 140
770 STOP
780 LET T1=T0+10127*E+X2-X
790 LET D0=.5*(1-N)*(X-X1)*(1+SGN(X-X1))
800 LET D1=(1-C)*(.25*(X2-X1)*(1-SGN(X-X1))+.25*(X2-X)*(1+SGN(X-X1)))
810 LET D=(382800+D0+D1)/(953000+382800+D0+2*D1)
820 LET T2=228180+.65*((953000-400000)+D1-(X+23600)*(1-D))
830 LET T=T1
840 LET F=T2-T1
850 RETURN
860 END
```

RUN

HR13270 15:52 09/15/69 MONDAY NYC

THIS PROGRAM COMPUTES THE VALUE OF THE 'CRITICAL CHARITABLE CONTRIBUTION' WHICH CAUSES THE DECREASE IN CHARITABLE CONTRIBUTIONS TO EQUAL THE INCREASE IN TAXES WHEN THE PROVISIONS OF H.R. 13270 ARE APPLIED AND COMPARED WITH THE RESULTS DERIVED FROM THE PRESENT TAX LAW.

ENTER MAXIMUM CASH CONTRIBUTION X1? 45600
ENTER MAXIMUM TOTAL CONTRIBUTION X2? 300000
ENTER TAX UNDER EXISTING LEGISLATION? 371560

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? NO
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
20897	650662	279102	279102

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? NO
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
20897	650662	279102	279102

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? YES
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
39030	642656	271096	260969

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? YES
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
39030	642656	271096	260969

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? NO
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
163750	507809	136249	136249

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? NO
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
176914	494645	123085	123085

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? YES
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
179752	501934	130374	120247

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO CONTRIBUTIONS? YES
DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

CRITICAL CHARITABLE CONTRIBUTION	TAX UNDER H.R.13270	TAX INCREASE	CONTRIBUTION DECREASE
195798	485888	114328	104201

DO YOU WISH TO CONSIDER OTHER OPTIONS? NO

TIME 0 MINS. 1 SECS.

SCHEDULE E

TAXPAYER MODEL

SUPPLEMENTAL INFORMATION

Assumptions	Total desired contribution	Required contribution reduction	Balance for contribution	Percentage contribution reduction	Federal income tax at balance for contribution
Pay increase in Federal Income Tax resulting solelv from the requirement to allocate charitable contributions and assuming sale of securities withheld from charity (H.R. 13270 and H.R. 13270 Modified by Administration's Proposal)	$300,000	$260,969	$ 39,031	86.99%	$642,656
Pay full increase in Federal Income Tax resulting from proposed changes but without sale of securities withheld from charity:					
H.R. 13270	300,000	136,250	163,750	45.42%	507,809
H.R. 13270 Modified by Administration's Proposal	300,000	123,086	176,914	41.03%	494,645
Pay increase in Federal Income Tax resulting solely from the requirement to allocate charitable contributions and without sale of securities withheld from charity:					
H.R. 13270	300,000	120,248	179,752	40.08%	501,934
H.R. 13270 Modified by Administration's Proposal	300,000	104,202	195,798	34.73%	485,888

Summary of Statement
by
Stanley S. Surrey
Before the Committee on Finance, U. S. Senate
on the Tax Reform Act of 1969
September 25, 1969

The Tax Reform Act of 1969 is a very significant step forward in the accomplishment of the vital task of reform of the Federal tax structure. It is not the end of the road, but it is a major beginning that takes us a considerable way forward. In the area of tax reform, major beginnings are certainly major events.

Individual Income Tax

The House Bill is a major step forward in beginning to meet the problems of tax reform under the individual income tax:

-- As to low-income taxpayers, the Bill fully meets the problem of the present system, that of taxing those below the poverty level and placing unfair burdens on those low-income families above that level.

-- As to middle-income taxpayers, the Bill meets the major goal of restoring tax simplicity and tax equity in the case of the personal deductions by significantly increasing the standard deduction. The Bill could be improved by revising the tax treatment of the elderly and disallowing the gasoline tax deduction.

-- As to high-income taxpayers, the Bill commences in a significant way to restore tax fairness through its elimination of the unlimited charitable contributions deduction; its removal of the alternative rate on capital gains and the extension of the six months holding period to a year; its provision for future issues of taxable state and local bonds; its partial cut-back on the tax preferences accorded real estate -- a cut-back which should be pushed further; and a number of other special matters. Its adoption of the minimum tax or limit on tax preferences and allocation of deductions provisions provides a partial offset to the remaining preferences that will, if properly

implemented, serve to prevent the gross escapes from tax that are now prevelant. But these two provisions as presently structured have serious omissions which should be corrected.

-- The Bill falters seriously in its treatment of farm tax losses and embarks on an unwise approach in placing a 50% limit on the top marginal rate applicable to earned income. It also unwisely introduces a new tax incentive in the five-year amortization of certain rental housing rehabilitation expenditures.

Corporation Income Tax

The House Bill is a significant step forward in beginning to meet the problems of tax reform under the corporate tax:

- With respect to the industries with the present lowest effective rates:
  - As to financial institutions, the Bill brings the effective tax rates of the commercial banks, mutual savings banks and savings and loan associations closer to those paid by business generally, and also reduces the range of differences within these institutions themselves.
  - As to natural resources, the Bill reduces the percentage depletion rates by about 25% and ends the abuses associated with mineral production payments. But it fails to deal with the aspect of intangible drilling expenses in the oil industry and the tax preference accorded to timber.
- With respect to other preferences:
  - The Bill ends the tax escape now provided for multiple corporations.
  - The Bill cuts back on the tax preferences accorded to real estate.
  - The Bill strengthens the rules governing foundations and other tax-exempt organizations.

But the Bill has a serious weakness in the addition of new tax incentives:

- The five-year amortization for pollution control facilities.

-- The five-year amortization for housing rehabilitation expenditures.

-- The seven-year amortization for railroad cars.

Pessimism and Tax Benefits

There is no one so pessimistic about the future of the country as an industry or taxpayer faced with losing a tax preference. These Hearings seem replete with industries and taxpayers who can see only gloom ahead. The correlation between pessimism and tax benefits is indeed high, for these prophets of gloom assert that their pessimism for the future should be reflected in continued or increased tax preferences.

Most of the pessimism is self-assertion, for there are few, if any, studies that document the beliefs. All see the tax system as a device to pour out financial assistance to industries and activities that do not want to trust to the marketplace. The accent is not on private enterprise, but on private enterprise plus tax assistance. None is willing to pull back on the preferences so we can see if the pessimism is really warranted and to see if Government assistance is really needed. And then, if the assistance is really needed, to see it provided through direct expenditure programs.

It should be clear by now that this tax incentive rationalization, this infusion now of social goals into tax provisions adopted long ago without any thought of incentive or social programs or the like, can only be destructive of an equitable tax system and an efficient use of Government resources. It is the proper course now to cut back these tax incentives and await the future. The House Bill is a good start and should be pushed forward, not stripped back.

Rates of Tax and Revenue Cost

Those first in line for tax relief when reduction is considered feasible, are the low-income taxpayers. Those next in line are the middle-income taxpayers not itemizing deductions for personal expenses. The House Bill fully meets these two claims for relief. It then

goes on to reduce tax rates throughout the rate schedule. The result is a total long-run revenue loss of $2.4 billion.

Looking ahead to 1979, such a loss is hardly significant, considering the hazards of revenue estimates. In all likelihood such a tax reform bill cannot provide a net revenue gain, even though an appraisal of national priorities would put more emphasis on expenditure programs than such a large tax reduction. But aside from this thought, the margin for concern about the revenue aspects, i.e. the $2.4 billion loss in 1979 considered as an absolute matter, is small. The Treasury appears to recognize this, for its changes would leave a revenue loss of $1.3 billion -- the difference of $1 billion is hardly cause for major economic judgments.

The important matter is the composition of the tax reductions. The Treasury approach to the House Bill is to make the across-the-board individual rate reduction paramount and to strip back the relief for low and middle-income families. This is an upside-down view of the priorities for tax relief, a misstating of priorities, and a negation of the essential task of tax revision. The House Bill approaches that task properly by giving full relief to those first in line for it.

The tax liability reduction under the Treasury approach shows a large reduction in the $0 - $3000 bracket and then proceeds to a relatively flat decline from $5000 on to $100,000. In contrast, the House Bill shows significantly larger reductions up to the $20,000 bracket than the Treasury approach, and the slope of the tax reduction is far from flat. There is no question but that the House Bill has a fairer distribution of the tax reduction.

The Treasury approach, after cutting back the reductions in the low and middle-income brackets, is then to use the revenue so obtained to reduce the corporate tax rate by two points. Such a change is not defensible on tax equity grounds or on economic stabilization grounds. The Treasury desire to remove the investment credit was based on the ground that capital formation was at a high level now and no general investment incentive was

needed. From a stabilization standpoint there is no point in substituting a corporate rate reduction for the investment credit.

As to future growth and the relative balance between consumption and investment, we can afford to wait a bit until the present inflationary pace really wears away to see if capital formation will then lag. If it does, a resort again to an investment credit can be more meaningful than corporate rate reduction. There is no point now in choosing weaker devices on the assumption that capital formation may later need strengthening.

Conclusion

The Ways and Means Committee and the House have taken a significant step forward to the goal of a fairer and simpler Federal income tax. It is now up to this Committee and the Senate to make that step a decisive one. The House Bill is a fine structure to build upon. It can be strengthened in a number of ways and these weaknesses should be corrected. But its many, many strengths should be retained.

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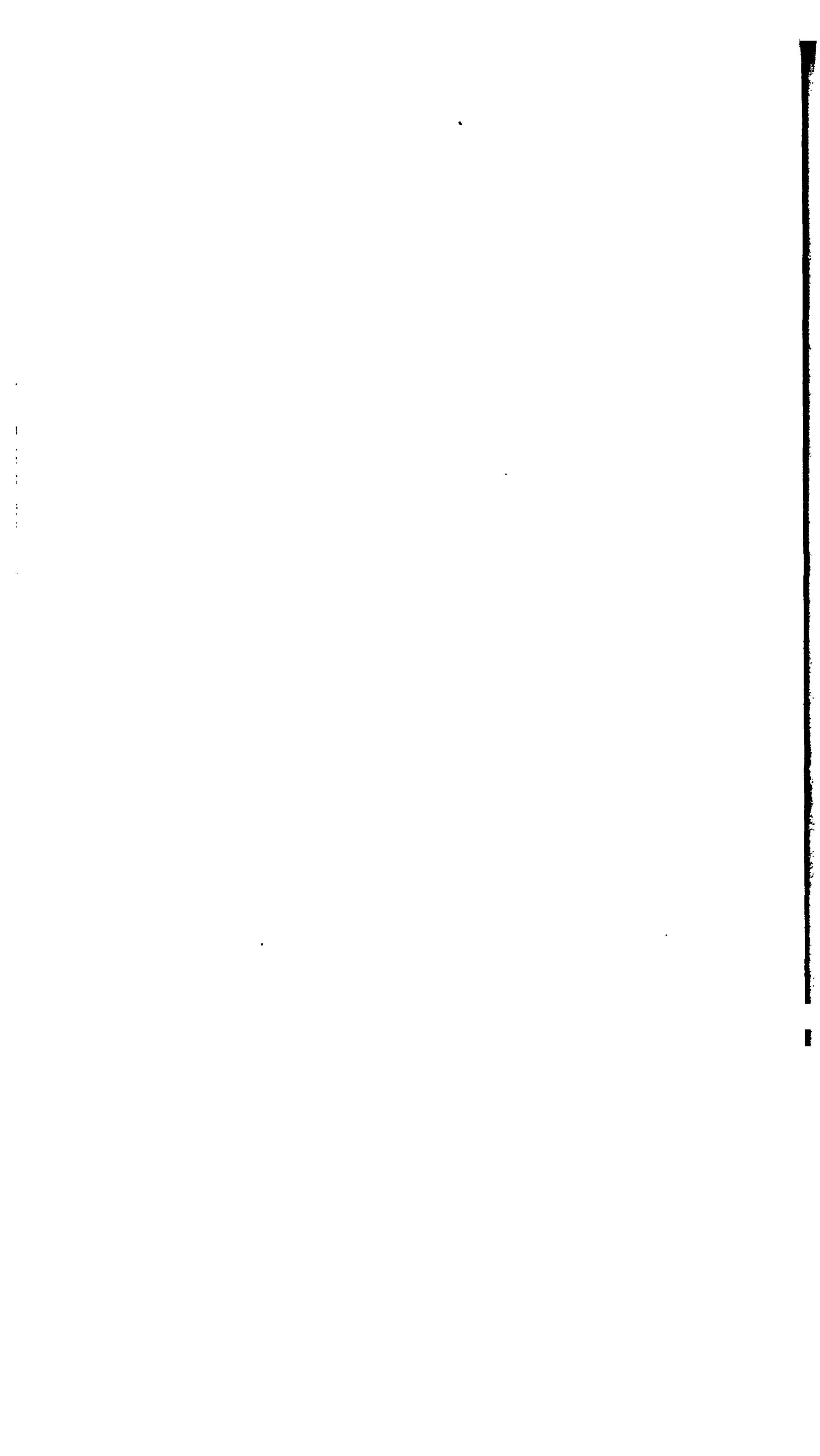

Statement By
Stanley S. Surrey
before the
Committee on Finance
U. S. Senate
on
The Tax Reform Act of 1969
H. R. 13270
September 25, 1969

I appreciate the opportunity to appear before this Committee in the Hearings on the Tax Reform Act of 1969.

The Tax Reform Act of 1969 is a very significant step forward in the accomplishment of the vital task of reform of the Federal tax structure. It is not the end of the road, but it is a major beginning that takes us a considerable way forward. In the area of tax reform, major beginnings are certainly major events.

Major tax bills are bulky, complex documents replete with technical language. It is often difficult to obtain an overall perspective regarding the basic aspects of such a bill - the significant changes that are involved, the degree of progress or retrogression in improvement of the tax structure, the swing of the pendulum toward tax simplicity or tax complexity. I believe it would be helpful in obtaining perspective on the effectiveness of this bill in achieving tax reform to consider first the dimensions of tax reform -- that is, what are the problems or issues of tax reform -- and then to see what the bill actually does in meeting those problems and issues.

Individual Income Tax

I will start first with the individual income tax. A consideration of the dimensions of tax reform under the individual income tax indicates that several distinct factors are involved. Some

factors are paramount for one group of taxpayers, while other factors predominate for the remaining groups. These different factors, of course, call for different approaches. Hence, I will separate these considerations into three broad taxpayer classes -- low income, middle income and high income -- and discuss the factors that are relevant to each group and the pertinent provisions of the House Bill.

Low-Income Taxpayers

The significant factor regarding low-income taxpayers is that the individual income tax is imposed on people whose incomes fall below the poverty line, and also bears heavily on those close to the line. Since that line is intended to measure the levels of income, by family size, which are barely sufficient to provide the necessities of life, there is justification for concluding that the income tax should not reach down below those levels. While poverty line definitions are to some extent arbitrary, so also is any cut-off utilized under the income tax, and the poverty line classification can well be used as a presumptive point for fixing the line of exemption from the income tax. The present income tax exemption levels, based on the combination of the $600 per person exemption and the minimum standard deduction, are considerably below the poverty line levels, especially for single persons and married persons with no or few children. Thus, a single person with income above $900 is subject to income tax, and yet the poverty line for single persons is around $1700; a married couple pays tax if their income is above $1600, whereas the poverty line is about $2200. There are about 2.2 million families in poverty who are now subject to tax.

The income tax change best designed to relieve this situation is to increase the present minimum standard deduction. Revision in the amount of that deduction will concentrate the revenue involved in the lowest income group and among single persons and married persons with small families, where, as stated above, we find the widest disparities between the present income tax exemption levels and the poverty line. No other tax change --

increase in personal exemption, decreases in tax rates, etc. -- will accomplish this purpose with the same effectiveness. The revenue cost depends on the amount of increase that is made in that deduction and the manner of its application.

The House Bill fully meets this problem of tax reform for the low-income taxpayers. It raises the present minimum standard deduction from $200 (plus $100 for each personal exemption) to $1100 per taxpayer, effective in 1971. (The name is changed from "minimum standard deduction" to "low income allowance.") The effect of the change is to place the start of the income tax at essentially the poverty level - thus fully exempting those below that level - and to give substantial tax relief to low-income families in the area above the poverty level.

This approach is far preferable to that contained in the earlier version of the low-income allowance (H.R. 12290) which involved a scaling-down of that allowance, so that it eventually disappeared and only the present minimum standard deduction remained. Such a scaling-down is retained in the current House Bill for 1970 and a modified permanent scaling-down has been recommended to your Committee by the Treasury Department. But a scaling-down approach is decidedly undesirable in meeting the problems of low-income taxpayers. While the initial allowance does exclude those below the poverty level from the income tax, the scaling-down has the effect of providing less relief to those low-income families above the poverty levels and far less overall relief to the lowest brackets than does the undiluted approach taken in the House Bill for 1971. Thus, that Bill achieves $2.6 billion of tax relief for these low-income families as compared with only $625 million under the scaling-down approach in 1970 (the original Treasury approach) and only $920 million under the latest Treasury scaling-down proposal.

The scaling-down approach also has the decided disadvantage and unfortunate effect of providing a high rate of tax for all low-income taxpayers who remain subject to tax. Thus, in 1970, under the general rate scale in the House Bill (which is the same

as present law) the first bracket rate on income above the exempt level is 14% on the first $500, 15% on the second $500, 16% on the next $500, and so on. Under the scaling-down approach in the Bill, however, the rates in effect for 1970 are much higher -- for example, the starting rate really becomes 21% instead of 14%. Thus, under the new table for that year, a single person is exempt if his income is below $1700. As he earns income in excess of $1700 his tax rate is 21% on the first $500 earned, 22-1/2% on the next $500, and 24% on the next $500. The same effect exists for married persons. This is because the taxpayer not only pays tax on each dollar he earns, but each such dollar also adds $.50 more to his taxable income because his low-income allowance is sliced $.50 for each $1 of income. These high rates do not show up in the law or tax returns because the tax is stated only in table form -- nor are they discussed in the House Committee's Report or the Treasury proposals. But the disadvantage of very high marginal rates for these brackets exists under the scaling-down approach. Fortunately, the House Bill in 1971 eliminates the scaling-down and thus eliminates these high marginal rates for that year and thereafter.

However, under the permanent scaling-down approach now recommended by the Treasury, the aspect of high marginal rates would persist. The scaling-down is slower -- the low-income allowance would be sliced $.25 for each $1 of income -- and the marginal rates would not be as high as in 1970, but they would be high. Thus, in 1971, when the general rates are stated to be 13% on the first $500, a low-income person subject to tax would under the Treasury approach actually have a rate of 16-1/4% on <u>his</u> first $500 of taxable income; when the general rate is 14% on the next $500, the low-income person would actually have a rate of 17-1/2% and so on. Thus, for low-income taxpayers, the tax tables under the Treasury scaling-down really involve actual tax rates 25% higher than the rates used in the general rate tables and which people presumably think are the rates applicable.

It is right to exempt from tax completely those persons whose incomes are below the poverty level. It is not right -- as the Treasury would do -- to tax at high rates those persons whose

incomes are just above the poverty levels. The House Bill in rejecting a permanent scaling-down is thus distinctly preferable to the Treasury recommendation to use that device.

Middle-Income Taxpayers

In 1944 the Congress took a major step to improve the simplicity and fairness of the individual income tax when it adopted the standard deduction -- at 10% of gross income up to a maximum deduction of $1000. This standard deduction was then used on about 82% of the tax returns. This action had two consequences: From the standpoint of simplicity, for the great mass of taxpayers the computation and record keeping under the income tax were greatly simplified. From the standpoint of fairness, for this group variations in deductions for personal expenses would not affect tax liabilities so that the tax burden was the same within the range of the average for these deductions. Only those taxpayers with personal expenses above the average could affect their tax liabilities through those expenses.

Since 1944, however, these important gains in simplicity and equity have steadily eroded away. In 1969, it is estimated that only 57% of tax returns will utilize the standard deduction. In the intervening years, average deductions have risen, making the 10% figure inappropriate, and incomes have also risen, making the $1000 limit inappropriate; yet those two aspects of the standard deduction have remained unchanged. The result is increased complexity for taxpayers, and a greater spread of actual tax liabilities for taxpayers largely similarly situated.

It must be remembered that many taxpayers who actually bear the burdens of these personal expenses cannot obtain the itemized deductions for those expenses since they do not directly pay the items, such as tenants who in their rent bear the costs of property taxes and interest. In these cases, the purpose of the standard deduction is to prevent serious unfair distinctions in tax burdens. And even where there are actual variations in personal expenses, the precise reflection of those variations in many cases would produce only small tax differences, whose reflection in tax

liability is out of all proportion to the complexity involved in keeping track of the items. This is especially so where the deductible personal expenses themselves raise qualitative judgments on which people differ. In these cases, the standard deduction serves to prevent taxpayers from being involved in excessive costs to obtain at best minor equity advantages.

As a result, our goals of simplicity and fairness point in the case of this group of taxpayers -- those with incomes from about $7000 to $25,000 -- to a revision which would restore, as far as possible, the effectiveness of the standard deduction. This step requires both an increase in the 10% figure and the $1000 limit, and the revenue cost involved depends on the extent to which these amounts are increased.

The House Bill here also meets the problem of tax reform for this group of taxpayers. It increases the standard deduction to 15% by 1972 and raises the limit to $2000. The effect, in combination with other changes in the Bill, would be that about 80% of returns would again be using the standard deduction. This is clearly a major gain in both tax fairness and tax simplification.

The Treasury recommendation to your Committee to increase the standard deduction only to 12% and $1400 is a decidedly inferior approach and should not be adopted.

A word as to revenue costs and the priorities for tax reduction may be appropriate here. The $1100 uniform minimum standard deduction or low-income allowance with no scaling-down costs $2.7 billion under the House Bill. The 15% - $2000 standard deduction costs $1.3 billion. The revenue is well spent, however, and goes to the persons under the individual income tax who held the top priority for tax relief when revenues for that relief became available, as they do under this Bill. These are the people who are first in line for tax relief, for they are treated unfairly and less favorably than other taxpayers under the present law -- the low-income groups who can least afford the income tax burden and the middle-income groups who do not benefit from itemized deductions.

The Treasury, however, seems to have an upside-down view of the priorities for tax relief. It gives top priority to the across-the-board rate reduction under the House Bill in the individual tax of $4.5 billion, stating that it "represents reasonable,equitable tax relief" because it "does not discriminate between itemizers and non-itemizers, between homeowners and tenants" and so on -- "it provides even-handed non-discriminatory relief."

But the task of tax reform and tax revision -- when taxes are being reduced -- is to see whether the present treatment is fair or unfair and to correct injustices first rather than simply uniformly to change tax rates. Such a uniform adjustment is appropriate in a temporary measure adopted for economic stabilization reasons -- a 10% surcharge (though even here the lowest brackets were exempted) or a 10% reduction to avoid a recession. There the task is not to change existing relationships and not to consider basic tax policy issues -- these are to be left to permanent tax revision. But now we are engaged in just such a revision where the task is that of examining just who is treated more favorably and who less favorably under the tax system. To approach such a fundamental revision by saying, as does the Treasury, that the first tax priority is across-the-board rate reduction would mean we would never really ever deal with the basic issues in an adequate way. The Treasury approach is thus a misstating of priorities and a negation of the essential task of tax revision. The House Bill approaches the matter properly by giving full relief to those first in line for it.

Several additional matters not in the House Bill may be mentioned with respect to the middle-income groups. Another step that can achieve simplicity, and also is in keeping with tax fairness, would be to eliminate the deduction for state gasoline taxes where the item is a personal and not a business expense. Like the non-deductible federal gasoline tax, the state gasoline tax is essentially a charge for the use of highway facilities and, therefore, should not be deductible. This step is now recommended by the Treasury.

Simplification and fairness for this group also call for a complete revision in the tax treatment of the elderly. The present rules are a maze of complexity adding up to a full page on the tax return. They also involve unjustifiable discriminations among the elderly through differing tax treatment for different sources of income, here bearing adversely on those elderly who need to continue working after reaching age 65. Further, they provide unneeded tax relief for those elderly who are well-to-do. The February Treasury Proposals involved a complete revision of present rules, with a revenue cost of $80 million.*

High-Income Group

Breakdown in Fairness --

The problem presented in the high-income group is a complete breakdown in the fairness of the individual income tax. A few examples will illustrate this:

-- In 1967 there were 155 tax returns with adjusted gross income above $200,000 on which no income tax was paid, including 21 returns with incomes above $1 million.

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* Another desirable change, recommended in the February Treasury Proposals, was in the charitable deduction, under which that deduction would be allowed outside the standard deduction (i.e. allowed together with the standard deduction), but would be available only where the contributions exceeded 3% of adjusted gross income. This threshold would apply to taxpayers using either the standard deduction or itemized deductions. These changes in the charitable deduction, combined with the standard deduction changes, would reduce significantly the number of returns requiring record keeping and audit for personal items, while maintaining for all taxpayers, even those using the standard deduction, an incentive for charitable gifts above routine giving. The charitable organizations apparently oppose such changes. But they presumably overlook or misjudge its advantages. Under the House Bill, with its increase in the standard deduction, and no other change as respects charitable contributions, only about 15 million returns would be left to use itemized deductions and to claim a charitable deduction. Under the above proposal however, with the ability to claim a charitable deduction whether other deductions are itemized or not, even with a 3% threshold about 26 million returns would claim a charitable deduction. These proposals would thus provide a wider base for charitable support than simply changing the standard deduction.

But these figures do not measure the full degree of tax escape at this level. If actual incomes were used rather than adjusted gross income -- so that items such as tax-exempt interest, full capital gains, excess percentage depletion, farm "tax losses", excess real estate depreciation, and intangible drilling expense deductions were included in the total amount of income -- the number of individuals with incomes above $200,000 and $1 million who are paying no tax would be higher. This figure would provide a more accurate description of the escape from tax in this group. Thus, some individuals who now show up in Statistics of Income below $200,000 and even in the $0 - $3000 bracket or with a loss, and who are paying no tax, would -- if these excluded items were added to their adjusted gross income -- be in the above $200,000 group and even above $1 million -- and still, of course, be paying no tax. Present data, however, presumably do not permit a statistical reclassification on this basis.

-- For those who pay tax, in the group with over $1 million of actual income (before personal expense deductions), the effective rate of tax for about 75% of the group clusters in the area between 20% and 30%.* This may be compared with taxpayers in the group between $20,000 and $50,000 of actual income, where about 60%** cluster in the same effective rate area between 20% and 30%, yet the $1 million and over group per taxpayer have probably over 50 times as much income.

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* 36.6% in the range 20%-25%, and 37.3% in the range 25%-30%. The $500,000 - $1 million group reflects a similar cluster, 64.7%. Even these figures are an understatement, since the actual or total income data do not include excess real estate depreciation, farm "tax losses", and intangible drilling expenses.

** 45.3% in the range 20%-25%, and 13.5% in the range 25%-30%. 27.9% are in the range 15%-20%.

-- For taxpayers up to the level of $50,000 of actual income, although there is dispersion within each group, the central range of effective rates moves upwards as income rises; for groups above $50,000, this upward movement in effective rates begin to flatten; and above $100,000 the central range of effective rate moves backwards to produce the results described for the $1 million and over group.

The obvious departure from the ability to pay concept and from elementary standards of fairness is self-evident in these statistics. Whether a person is below the poverty line, whether he is in the group between $20,000 and $50,000, or whether he is in-between, he is certainly warranted in feeling that the income tax is not working fairly.

Causes of Unfairness --

I would like to turn from these overall evidences of unfairness to the causes of high incomes showing these low rates or complete absence of tax, since the causes will point the way to possible approaches for correction.

In overall effect, the causes lie in a combination of excluded income items and the method of applying itemized deductions.

As to the excluded items, looking at the significant ones, the list covers:

- the excluded half of realized capital gains
- interest on state and local bonds
- accelerated depreciation largely on buildings
- deduction for unlimited charitable contributions (almost entirely of appreciated securities whose gain is not taxed)
- farm "tax losses"
- excess of percentage depletion over cost of investment
- intangible drilling expenses of oil wells.

For many persons, these items singly or in combination bring the tax to zero. Thus, for somewhere around 50 to 75 persons, the unlimited charitable deduction benefit simply eliminates tax.*

* See specific cases 1 - 4 in the February Treasury Proposals, pp. 90-91, involving persons with actual incomes of $10 million, $6 million, $8 million, and $6.5 million.

For others, percentage depletion or intangible drilling expenses*; real estate deductions, mainly accelerated depreciation**; or farm "tax losses"*** are the factors that produce a zero tax.

For a large group, the effect of these items while not completely eliminating tax, is to reduce the taxable income considerably below the actual income. Then another factor enters -- these persons usually have large personal expense deductions which they itemize. These itemized deductions are offset against the remaining taxable income, and in no way are allocated to the excluded income, although excluded as well as taxable items are a source for the itemized deductions. Hence, the full force of the itemized deductions is concentrated against the taxable income and the result is a very low or even zero tax.****

The interest deduction, usually arising from loans to carry capital assets which result in excluded income or no current income, is here an important factor. So also is the general charitable contributions deduction, which for this group usually involves not cash gifts but gifts of securities whose appreciation is not taxed though the appreciated value measures the deduction.

This steady deterioration of income taxation in the case of high-income individuals has been hastened by the "institutionalization" of tax escapes. The "packaging of tax shelters" by investment houses, brokerage organizations, and others has made these shelters readily available to those with incomes high enough to utilize their attractions. Just as in the case of the stock market, geography is not a factor -- the possessor of

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* See specific cases 8 and 9, p. 93, involving persons with $1 million and $1.3 million.

** See specific case 10, p. 94, involving a person with $1.4 million, and table 1, p. 452.

*** See specific case 11, p. 94, involving a person with $700,000.

**** See specific cases 5, 6, and 7, pp. 92-93, involving persons with $5.3 million, $935,000 and $1.3 million.

a tax shelter can live thousands of miles away from his cattle or his oil well or his orchard or his post office and in fact may never see them at all. It is clear that whatever may have been the origin of these shelters, it was no one's intent -- in the executive branch or in the Congress -- that this supermarket era of tax shelters was to be the end result.

These are the causes of unfairness -- what are the solutions adopted in the House Bill?

House Bill Solutions - Matters Dealt With Directly

Some of the items permitting escape from tax are dealt with directly in the House Bill.

Unlimited Charitable Deduction. The House Bill would, and properly so, eliminate the unlimited charitable deduction after a transitional period. While superficially this deduction may seem to have a certain appeal when loosely described -- a person must give away 90% of his income -- in actual effect the individual is not giving away income or assets but giving away his tax. The assets actually contributed are nearly always appreciated securities whose gain is untaxed and the income made tax-free is generally dividend income otherwise subject to a rate around 70%. I see no reason why one group of persons is permitted to give their tax to any charity they choose while others are required to pay their tax to the Federal Government. If all of us could choose either to pay our income tax to the Government or give it to our favorite charity we would have tax anarchy. This being so, no special group should be permitted this choice. The question of how large a tax subsidy should be given to charitable organizations under the income tax is one to be decided by the Congress. For most everyone this is controlled through the limit, now 30% of adjusted gross income, on the charitable deduction. This limit can be changed; the House Bill uses 50%. But the limit should apply across the board. All who have ability to pay should pay some tax to the Federal government, rather than be permitted to select a charity to the exclusion of the Federal government. Certainly, if only for the reason of tax morality, this should be true for

our wealthiest persons. The House Bill properly ends the unlimited charitable deduction.

Capital Gains. The House Bill would reduce the tax preference for capital gains by lengthening the holding period from six months to a year and eliminating the 25% alternative rate. These changes are proper improvements in the treatment of capital gains and their justification in terms of tax equity is clear. Most economists have for years urged at least changes along these lines. Equally, most economists who have studied the matter would find unconvincing the assertion that such moderate changes would have the calamitous effects on investment that critics of the changes usually charge.

The Treasury's objection to these changes is also cast in terms of effects on investment: "These changes...impose too great a burden on capital investment. The effect of the Bill would be to remove a large measure of the incentive for private capital to engage in new and expanded business ventures. Present capital investments would tend to be frozen and the economy as a whole would suffer." But these dire forebodings are strange indeed when placed alongside its actual recommendations. For the Treasury is obviously aware that the capital gain preference is the single most important factor in permitting high income persons greatly to reduce their effective rate of tax, so that the equity and fairness of the tax system are markedly reduced. Hence, it recommends a complex limitation on the use of the 25% alternative rate which is in effect a special minimum tax applicable to capital gains. Under this approach the revenue gain in the capital gain and loss area would be $425 million -- or about 66% of the House Bill gain of $635 million. It is hard to see how this $210 million additional gain under the House Bill -- less than 1% of the present yield from capital gains taxation of individuals -- can have the adverse effects on investment painted by the Treasury. In this light, the House Bill approach, which is direct and far simpler,

is to be preferred.*

We should recognize that the most serious aspect of our present capital gains policy is the permanent escape from tax of appreciation in assets transferred at death. Correction of this defect remains a matter of top priority. The House Committee Report states that reform measures relating to revision of the estate and gift tax laws and the related problem of the tax treatment of property passing at death will be studied as soon as possible, with a bill to be reported in this Congress. The accomplishment of this objective will move us considerably further along the road of meaningful tax reform.

State and Local Bond Interest. The House Bill begins to come to grips with the difficult matter of state and local bond interest --difficult because of its history and its place in federal-state relationships. The issue is clear: The present exemption for interest on state and local bonds has the general effect of a blanket, no strings attached, federal grant-in-aid to the issuing governments. It is achieved by giving tax favoritism to high-bracket individuals with conservative investment instincts, to commercial banks, and in lesser degree to some other financial institutions. The state and local governments clearly desire the general effect to continue. Those interested in the federal tax structure deplore the method of achieving this effect because of both the tax favoritism and the inefficiency or wastage involved in resorting to the technique of favoritism, in that more federal tax revenue is lost than the local governments obtain in aid. The federal revenue lost annually through the exemption is about $2.63 billion. The aid annually obtained by the states and local governments -- the amount saved through the lower interest rates on tax-exempt bonds -- is about $1.9 billion. (Parenthetically,

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* The definitional changes in the House Bill in the capital gain area - as to collections of letters, papers, and memoranda; the treatment of lump sum pension distributions (still inadequate as to appreciated property); franchises; casualty gains and losses; and sales of life estates (why is the income still considered capital gain?) are improvements over present law, as are the changes in the capital loss rules.

to put this form of federal aid in perspective, the total amount of grant aid to states and localities is about $25 billion.)

The state and local governments carry no brief as such for the federal tax windfalls and the wastage. Up to now, however, they have not seen any other mechanism which can achieve for them the general effect that the tax exemption produces. But the future heavy financial demands on state and local governments will diminish for them the amount of the grant-in-aid that the tax exemption mechanism produces. The restraint on the scope of the market for their bonds that tax exemption involves will cause their interest rates to rise. At the same time, the tax favoritism perversely is increased.

The inefficiency inherent in the use of the tax exemption mechanism to achieve the grant-in-aid will thus hurt all the governments involved. They now have a common interest in finding a better path to the grant-in-aid.

The House Bill provides the solution of taxable bonds issued on an optional basis by state and local governments. The federal taxation of these bonds would remove the present tax unfairness. Since the interest costs on taxable bonds would be higher than on tax-exempt issues, the Bill continues the aid to the states and localities by authorizing the Treasury to pay from 30% to 40% of the interest cost (25% to 40% after 1975). The payments would be to the issuing governments periodically as interest falls due. The payments would be automatic, with no strings attached. Hence, the automatic non-Federal control of the present aid would continue. The issuance of taxable bonds would be optional, so that the privilege still to issue tax-exempt bonds would remain.

It is difficult to see how states and localities can lose under this arrangement. On the contrary, depending on the level of the Treasury's interest payments, they could readily gain much through actual interest costs on their part becoming less for most localities than the interest costs on their existing tax-exempt bonds. The Treasury could even make its payments around 45% or 50% of the interest without losing any money. It would

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then simply be turning over fully to states and localities the amount that today goes wasted -- the difference between the earlier figures of $2.63 billion federal revenue lost and $1.9 billion state and local interest savings annually.

There can be improvements in the provision, perhaps fixing on a definite percentage of aid rather than letting the Secretary vary the figure. There can be problems of transition and adjustment. These are inevitable and all should work together to meet them. Also the present difficulties plaguing bond issuers, growing out of the unusually high interest levels reflecting inflationary forces and counter measures, should not cause us to lose perspective on the long-run aspects. Further, while there may well be shifts in the traditional patterns of investment dealer relationships and mechanisms, these shifts are hardly a matter on which to base policy objectives. There can be other alternatives to pursue, such as an Urban Development Bank. But these alternatives need not be competitors, but complementary solutions.

The matter must be kept in perspective. The House Bill offers a present, rational approach regarding future issues of state and local bonds. It should be accepted in this light and efforts made to perfect it rather than seek to tear it apart and strike it down. A solution of this character would both materially lessen the federal tax unfairness as future issues go out on a taxable rather than a tax-exempt basis and provide greater interest savings to states and localities without any federal control of their debt obligations.

Farm "Tax Losses". The House Bill unfortunately falters severely when it comes to the matter of farm tax losses. The abuses in this area have been well publicized. Essentially, Treasury regulations permit farmers to expense items which are capital items and so treated under commercial accounting principles -- items such as the costs of raising livestock and the costs involved in the pre-operation stage of orchards and ranches. (There are other departures from financial accounting,

such as the ability to use the cash method though inventories are involved). The ability to expense items that are capital in nature gives rise to current deductions that are in excess of the current income from the cattle or orchard or other activity. These excess deductions -- "tax losses" -- are quite valuable when other non-farm income is present, since the farm "losses" can then shelter that non-farm income from tax and thus leave the non-farm income -- be it executive salary, investment house or brokerage commissions, dividends and so on -- free of tax. The tax picture is made all the sweeter by the statutory treatment of the sale of the products involved -- the cattle or the orchard -- as a capital gain transaction, so that the end of the road can be 25% tax rates and not ordinary income rates. And the main road of tax shelter need have no end -- one herd of cattle can be sold and another started, one orchard sold and another planted.

Wealthy non-farmers have been made increasingly aware of the wonders of this tax system, under which the Government actually pays the non-farmer money just to own the cattle or orchard and the wealthier he is the more it pays him. These farm rules are thus a "negative income tax" for well-to-do non-farmers. The absurdity of the present rules is disclosed by data that show that as people rise in the income scale they would appear to have a remarkable propensity to run their farm operations at a loss -- the greater the income from non-farm sources, the greater the loss from farm operations. Since the data also indicate that people with high incomes do not show losses on other business ventures, we can hardly conclude that when they go into farming they uniformly stumble around and actually lose money due to mismanagement or bad investment decisions. Rather, when we observe the extensive literature which explains how wealthy people can save after-tax dollars through showing "tax losses" on farm operations, which really involve an actual net investment in the farm, and then shielding other income with those "losses", it is obvious that the prevalence of these "losses" is evidence of extensive use of a tax abuse.

The House Bill essentially does very little about this -- it raises $20 million when an adequate approach would produce at least $150 million. Its defects are two-fold: It continues to allow these artificial farm "tax losses" to be used currently but then would recapture them (the "excess deduction account") on any later sale of the assets by treating the gain on sale as ordinary gain rather than capital gain to the extent of the prior losses. The House Bill, by allowing artificial losses currently to be offset against and thus shelter non-farm income, permits the tax on that income to be deferred until a later date. For people in the upper brackets, tax deferral by itself is a valuable asset -- the Government in effect makes an interest-free loan of the tax amount and such loans in these days of 9% and 10% money are quite beneficial. In addition to this basic defect of structure in its solution, the House Bill imposes severe limits on the use of the solution: the farm loss must exceed $25,000 and the non-farm income exceed $50,000.

In contrast, Senator Metcalf and others have suggested a far better approach. This approach would not allow these artificial "tax losses" to be used currently, so that there would be no shelter of non-farm income. On any sale of the farm assets, the losses could then be used to offset any gain on that sale. His bill uses a limit of $15,000 of non-farm income, and this exclusion is phased out.*

The proper course in the farm area is to reject the House Bill approach and follow Senator Metcalf's approach.**

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* Senator Metcalf's bill could be strengthened by offsetting the disallowed losses against the full gain on any sale, before the application of the 50% capital gain deduction rather than after that application, as the bill now appears to provide.

** The House Bill provides for recapture of any excess depreciation deduction that may show up on a sale, as is done under present law with other tangible property generally, and this change is desirable. The Bill also strengthens the "hobby loss" provision (the Treasury suggestion of including anticipated increase in the value of the property as an indication of a non-hobby would seem a weakening of the House Bill). But these provisions are not substitutes for an adequate solution to the main problem; they are desirable complements to Senator Metcalf's approach to the main problem.

Real Estate. In many respects the real estate area is like the farm area, except that "real estate tax losses" are used as the shelter rather than "farm tax losses." The present tax laws grant excessively favorable accelerated depreciation to buildings, which provides far more rapid write-offs than straight-line depreciation. This excessive depreciation deduction, on top of the other expense deductions for interest and taxes, not only relieves real estate rentals from tax, but is so large that it spills over and shelters non-real estate income tax.

The investor is in many cases not interested in "cash flow" from the building but in "tax flow" -- how much by way of deductions for interest on the mortgage, real estate taxes, and accelerated depreciation will the building generate so that the resulting "tax losses" (deductions in excess of rental income) can offset dividend income, professional fees, salaries, etc., and thus "shelter" the latter from tax. The real estate shelter is especially attractive because all these deductions belong to the equity investor. Generally the equity investor can obtain a high leverage effect. Further, through deductions of interest and taxes during the construction of a building, he can often recover his equity investment before the rental lease even starts, so that the deductions available during the lease are all a return on investment. The rental under the lease will take care of the mortgage and real estate taxes.

For these reasons, the real estate shelter -- office buildings, motels, shopping centers, post offices, high rise apartment houses, industrial buildings and so on -- has had a broad attraction. Thus the announcement of the Government's decision to build a major post office is also a major event in the halls of those institutions that package tax shelters. Post Offices are privately owned and leased to the Government, thus making the real estate shelter available to the syndicate members who own the facility. The data, though not as complete as one would like, point to a far wider -- and still rapidly widening -- use of the real estate shelter than is generally realized. In fact, the use of this escape route may rank just after the capital gain factor in magnitude.

The House Bill makes a start on attacking this problem. It reduces accelerated depreciation on all new buildings, except new rental housing, to 150% declining balance depreciation instead of 200% declining balance and it limits used buildings to straight-line depreciation. It also applies the present recapture rules of personal property to real property, so that depreciation in excess of straight-line depreciation is recaptured on sale by converting capital gain to ordinary income to the extent of the excess.

The allowance under the House Bill of 150% declining balance depreciation for new buildings is still on the over-generous side, and straight-line depreciation is more appropriate. Another desirable step would be to require the capitalization of interest and taxes paid during construction. The present option to expense these costs is at variance with proper accounting procedures and operates to accentuate the real estate shelter. The current deduction of these capital costs often returns to the investor nearly all of his equity investment at the outset. With nothing in effect at risk, the benefits of excessive depreciation are pure tax profit to him.

The House Bill does not change the depreciation provisions applicable to rental housing, though no reason for the exception is advanced. The Government does have an interest in encouraging rental housing. Government non-tax programs to aid such housing, however, do not indiscriminately apply to all housing, but focus instead on housing for low and middle income families. The House Committee Report itself criticizes the use of tax benefits for luxury housing:

> "In the housing field the tax stimuli are more effective for luxury- and moderate-income rental housing where profitability and appreciation prospects relative to risk are inherently more attractive than in lower-income housing.
>
> The "trickle down" supply effect for the lower income rental housing market is slow and uncertain in a growing general housing market.
>
> Capital and other resource demands engendered by the existing tax stimuli tend to expand luxury housing, commercial, office, motel, shopping center, and other forms of investment, squeezing out lower income housing."

And yet the Bill retains tax benefits for all housing, including luxury housing. There is no Government expenditure policy to aid luxury, high cost housing. Why, therefore, should we have a tax policy that in effect spends Government funds for such housing instead of concentrating Government financial assistance where it is needed. At the least, the benefits of accelerated depreciation should be retained only for the type of rental housing that is assisted under direct expenditure programs.

Even as to such housing it would be desirable to phase out the tax assistance and allow the funds which that assistance represents to be used directly by HUD in its programs. A termination date should therefore be put on this tax incentive for such housing, and arrangements explored to achieve a transfer of the funds involved at that date from the "tax expenditure budget" to the regular Budget for housing.

The House Bill introduces a distinctly unwise tax policy when it provides for five-year amortization of certain costs incurred in the rehabilitation of low-cost rental housing. This is an expensive tax incentive -- the revenue cost is put at $330 million. There is no discussion in the House Report, and no study referred to, indicating that if the Government is suddenly to spend $330 million more on housing, it should be spent in this fashion. There is no indication that rehabilitation of low-cost buildings has this high a priority or that this type of program and assistance is the most effective that can be devised. Because of the difficulties involved in rehabilitation, HUD up to now seems to have given it a low priority. Scarce funds must be allocated over many needs and apparently the economics of rehabilitation are such that the money is better spent in new construction. If HUD and the Congressional Committees concerned with housing have come to this conclusion, it would seem irrational for the Treasury and the Ways and Means Committee suddenly to start spending Government funds on a different basis. Surely with other established housing programs not fully funded, a better use for this $330 million exists. It is one thing for HUD to accept money from any source and not turn down such gifts, but this is hardly a wise use of scarce Government resources.

The Treasury itself seems to have reservations on tax incentives in the housing area, for it states:

> "We are concerned with the continued heavy reliance upon tax incentives as a means of achieving our national housing goals, and believe that consideration should be given in the near future to other additional methods of doing so."

Given this concern, it is difficult to perceive the wisdom of suddenly launching a new tax incentive with no study behind it and in an area that seemingly has been regarded by housing experts as having a low priority when it somes to spending Federal funds.

Together with the continued accelerated depreciation assistance for all rental housing, we presumably will be spending over a half-billion dollars through the tax system on such housing. It would be far wiser to turn these funds over to the non-tax expenditure programs of Government.

Natural Resources. I will discuss the matter of percentage depletion and other natural resources tax changes in connection with consideration of the corporate tax.

Other Items. The House Bill in a number of areas has desirable corrective provisions that will strengthen the equity of the individual income tax, which I will here merely list:

-- the requirement that corporate earnings and profits be computed on the basis of straight-line depreciation, thereby ending the present system of creating tax-free dividends to shareholders, especially in the public utility area, through computing earnings and profits on the basis of accelerated depreciation.

-- the taxing of distributions to beneficiaries of accumulation trusts and multiple trusts at the tax brackets applicable to those beneficiaries rather than, as at present, at the lower tax rates applicable to the trusts.

-- the tightening of the rules regarding restricted stock compensation plans.

-- the tightening of the rules regarding the treatment of stock dividends when two classes of stock exist and the rules regarding stock dividends on preferred stock, the changes in effect largely embodying existing regulations in the statute.

-- the revision of the treatment of employee deferred compensation so as to allocate its consequences for tax purposes to the years in which the compensation was earned.

House Bill Solutions - Overall Approaches

In addition to the above direct approaches, the House Bill has two overall approaches, or back-up provisions, designed to increase the fairness of the tax. These two approaches are a minimum individual income tax or limit on tax preferences, and the allocation of deductions.

Limit on Tax Preferences. The limit on tax preferences -- or minimum income tax -- is premised on the position that whatever may be the merits of the major tax preferences that are retained, of overriding importance is the principle that every individual with substantial income should pay a minimum tax toward the cost of Government that itself bears a relationship to the economic income involved. To achieve this, under the House Bill a 50% ceiling is imposed on the amount of a taxpayer's total income (taxable items plus tax preference items) that can be excluded from tax. In other words, speaking generally, if the tax preferences exceed 50% of total income, the excess becomes taxable.*

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* The technique is similar to Senator Harris' minimum tax bill, except that Senator Harris' bill would apply the regular tax rates to any part of the 50% of capital gain that is reached by the minimum tax, thus not making the 25% alternative rate applicable to that part. This was the effect of the February Treasury Proposal for a minimum tax. The House Bill version does not alter the 25% alternative rate. This is done under the direct changes in capital gains.

The tax preferences covered by the House Bill are state and local bond interest (included gradually over 10 years); one-half of capital gains; appreciation in value of property contributed to charity; excess depreciation on real estate; and farm tax losses.

Two important items are missing from this list: percentage depletion and intangible drilling expenses. These omissions are serious aspects, since for those engaged in natural resources activities, the effect of the limit on tax preferences is fully negated. There is no reason to omit these items. The theory of a minimum tax -- or a limit on tax preferences -- is not to pass judgment on any particular tax preference. The theory instead accepts the view that for one reason or another the particular preference is to remain. But the theory asserts an overriding concept of tax equity that there must be scope for the principle that each individual with significant amounts of income must pay some tax to the Government. Any preference, no matter how meritorious it is considered by its adherents, must make accommodation to this competing principle of tax equity. In this light, percentage depletion in excess of capital investment and intangible drilling expenses should be covered as preference items. The Treasury so suggests, though it would still exclude intangible drilling expenses of individuals whose principal business is exploration for oil and gas. Obviously such an exception is at variance with the principle of the limit on tax preferences and is unadvisable.

The Treasury suggests three additions to the list of tax preferences: interest and taxes paid during the period of construction of a building; excess depreciation in the case of a lease of equipment and other personal property; and the new five-year amortization of rehabilitation outlays for low-cost housing. The first two additions are desirable assuming the matters are not dealt with directly, which would be preferable -- the interest and taxes should be capitalized as stated earlier; the lease abuse could be handled, even administratively, by a better delineation between what is really a sale by the

purported lessor accompanied by a loan, since many of these leases are essentially financing arrangements, and what is a real lease. The third addition indicates the error of embarking at all on the new tax preference for rehabilitation.*

Allocation of Deductions. As stated earlier, income excluded because of tax preferences provides in effect a double benefit -- the income is excluded and the taxpayer is then permitted to reduce his remaining income by the full amount of his itemized deductions. To eliminate this double benefit, the House Bill contains an allocation of deductions requirement. Under this provision itemized deductions must be allocated between taxable income and excluded income. The portion allocable to the excluded income would not be allowed as a tax deduction.

The proposal is clearly appropriate. The policy issue involved is the content of the tax preferences that are taken into account in determining the excluded income. The House Bill parallels the limit on tax preferences proposal by covering the same preferences, with two exceptions. It here does cover percentage depletion and intangible drilling expenses, which is proper (and with which the Treasury agrees, without any of the exceptions as to intangible drilling expenses of those engaged in the oil business). It here excludes, however, interest on existing state and local obligations, which is wrong. The Treasury here recommends existing obligations be covered, without any ten-year phase-in. The Treasury here also recommends the additional three matters mentioned under the limit on tax preferences.

The proper course is to make the two provisions, allocation of deductions and limit on tax preferences, parallel in scope. Moreover, the two provisions should be given a wide scope, in keeping with their back-up objective to maintain a degree of tax equity despite the various factors which require the continuation of some tax preferences. Hence the proper course is to provide a parallel treatment by including the wider coverage in each case where there is a difference in the House Bill.

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* The House Bill applies a five-year carryover rule to the limit on tax preferences. This seems unwise and to improperly dilute the application of the limit.

A word should be added as to two items. In the case of state and local bond interest, the Treasury urges that the interest not be covered under the limit on tax preferences because of doubts as to the constitutional validity of that step. No legal opinion has been provided by the Treasury or the Department of Justice stating that the inclusion would be unconstitutional. Moreover, both Departments in the past have published opinions affirming the constitutionality of the taxation of such interest. It would appear to be the proper course on this record to at least allow the Supreme Court to render its judgment. Others have urged that under both LTP and Allocation that interest on existing obligations not be covered (and the House Bill so provides as to Allocation), presumably so as not to defeat expectations of existing holders. This argument goes too far, for it would sanction the assertion of a vested interest in a tax preference and in a situation even where full taxation is not involved.

Moreover, the argument overlooks the effect of the provision under the House Bill for subsidized future issues of taxable state and local obligations. Under that provision, if a significant amount of such taxable bonds are issued -- and there is no reason why this should not result -- tax-exempt bonds will begin to become a relatively scarcer commodity and the value of existing obligations will accordingly rise. Thus a windfall benefit would be granted to existing holders. The inclusion of existing obligations under the LTP and the Allocation provisions is thus but an offset -- and not too strong an offset -- to this windfall benefit. It is hard in this light to see any ground for complaint by existing holders. There is also no reason for any slow phase-in, as under the House Bill. Further, the coverage of existing bonds cannot as such affect state and local governments, for the bonds have been issued. The rates they must pay on their future issues will be determined far more by the effect of the taxable bond option than by inclusion of obligations, existing or future, under LTP and Allocation.

A second aspect concerns appreciated property given as a charitable contribution. The House Bill treats the non-inclusion in taxable income of the appreciation as a tax preference - which it is - and therefore covers such appreciation under the LTP and Allocation proposals. The Treasury now suggests that this coverage be deleted because it believes it would unduly restrict public support of charitable institutions. Such exclusion, however, would clash with the basic rationale underlying these two back-up provisions, for their operation as stated earlier is not dependent on the reasons for the tax preference. In the final analysis, all tax preferences exist because the Congress decides that financial assistance is to be given through the tax system to the activities involved. The LTP and Allocation proposals set up a balancing principle, that the financial assistance be tempered by some adherence to the principles of tax equity. This balancing principle is applicable to appreciated property given to charity as well as to the other tax preferences.

Moreover, there is no reason why donors of appreciated property should have a greater opportunity to place Government resources at the disposal of charities -- which is the effect of the tax benefits given to gifts of appreciated property -- than donors of cash. I very much doubt that the Congress would provide directly that if a person contributed $100,000 in fully appreciated property he could deduct say 135% of the gift but if he contributed $100,000 in cash, he could deduct only 100% of the gift -- yet such a discriminatory result is the general effect of our present rules. The existing law does discriminate in favor of the donors of appreciated property and their value judgments as to which institutions and charitable functions to support. The issue is a troublesome one, not because of its tax aspects because the tax answer is clear, but because of the values we ascribe to our charitable institutions. But one can well fear that an exception on this ground can lead to other exceptions in favor of those who will argue -- and they will -- that their tax preferences also serve worthwhile purposes, and soon the LTP and Allocation provisions would be eroded away.

Other Provisions in House Bill

Limitation on Interest Deduction. The House Bill contains a limitation on the deduction of personal interest on funds borrowed for investment purposes. The limit would be that of investment income including capital gains plus a $25,000 floor. The limit would not extend to interest on funds borrowed for business purposes or for a home mortgage.

Studies of the tax returns of high-income individuals underscore the importance that the interest deduction plays in permitting these individuals to achieve low or non-existent tax liabilities. Long ago it was recognized that the interplay between deductible interest on borrowed funds and favorable tax treatment of the activity in which the funds were invested would play havoc with the fairness of the individual income tax. Present law thus disallows the deduction of interest when it is connected with tax-exempt bonds. But to confine the restraint on the interplay to this narrow area is obviously inadequate to meet present day tax-escape sophistication. The House Bill approach is especially important in the case of growth stocks and other assets which appreciate over time without a current cash flow. Our present law does not tax current appreciation in value until it is realized by sale, and this deferment of tax is in itself valuable. The denial of a current interest deduction would thus match the deferment of the inclusion in income of the appreciation. Further, if the asset is retained until death, the appreciation entirely escapes income tax.

The Treasury argument that the provision discriminates against the person with earned income, no investment income, but borrowings invested in growth assets is hardly an adequate reason to drop the provision. In a sense, in terms of the ratio of borrowings to tax-sheltered property, such a person has the highest ratio, 100%, and in that sense is maximizing the use of the interest deduction. Nor would such a person be hampered by the Allocation of Deductions proposal. In the case of the interest deduction, it has become clear that a direct limitation is needed, in addition to the Allocation provision, and the House Bill provides this strengthening.

Earned Income Maximum Rate. The House Bill provides that the tax rate on earned income shall not exceed 50%, so that this figure becomes the maximum marginal rate for earned income. I believe this provision to be unwise and the wrong approach to setting limits on the progression of the income tax.

A principal reason advanced for its support is that it will cause executives and self-employed persons to be satisfied with the lower tax result on their earnings and not seek tax shelters. This does seem a peculiar way to reward the past pursuit of tax shelters. Moreover, the top rate of 50% would remain even if these individuals continue to pursue tax shelters. Under the House Bill, for example, an executive can have his lower tax on earned income and also his tax shelter of depletion and intangible drilling expenses, which are not covered by LTP, or of interest on existing state and local bonds under the Treasury approach. More important, the executive or self-employed person can have his lower tax on earned income and also have securities which are appreciating in value and which appreciation will not be taxed at his death.

If we are to set limits on the progression of the individual income tax, we should at least follow two principles: one, the limit should be in terms not of a marginal rate but an overall effective rate of tax; two, the effective rate should be in terms of an individual's total economic income and not just in terms of taxable income without regard to his untaxed income. Nor should we rush into limits on progression until we have really covered all the serious avenues of tax escape, and that of appreciated securities transferred at death remains wide open. We may when the serious escape avenues are closed be ready for a properly tailored maximum effective rate on all income. But we are still a long way from the point where we should so seriously blunt the progression of the tax as does the House Bill and the Treasury proposal respecting earned income.

Summary as to Individual Income Tax

The House Bill is a major step forward in beginning to meet the problems of tax reform under the individual income tax:

-- As to low-income taxpayers, the Bill fully meets the problem of the present system, that of taxing those below the poverty level and placing unfair burdens on those low-income families above that level.

-- As to middle-income taxpayers, the Bill meets the major goal of restoring tax simplicity and tax equity in the case of the personal deductions by significantly increasing the standard deduction. The Bill could be improved by revising the tax treatment of the elderly, setting a threshold for charitable contributions and allowing them outside the standard deduction, and disallowing the gasoline tax deduction.

-- As to high-income taxpayers, the Bill commences in a significant way to restore tax fairness through its elimination of the unlimited charitable contributions deduction; its removal of the alternative rate on capital gains and the extension of the six months holding period to a year; its provision for future issues of taxable state and local bonds; its partial cut-back on the tax preferences accorded real estate -- a cut-back which should be pushed further; and a number of other special matters. Its adoption of the minimum tax or limit on tax preferences and allocation of deductions provisions provides a partial offset to the remaining preferences that will, if properly implemented, serve to prevent the gross escapes from tax that are now prevelant. But these two provisions as presently structured have serious omissions which should be corrected.

-- The Bill falters seriously in its treatment of farm tax losses and embarks on an unwise approach in placing a 50% limit on the top marginal rate applicable to earned income. It also unwisely introduces a new tax incentive in the five-year amortization of certain rental housing rehabilitation expenditures.

The Corporate Income Tax

The corporate income tax presents a different set of problems. We are not dealing with a progressive tax and the ability to pay concept that underlies such a tax. Nor, in the large, are the pressures for simplification so intense, though the less complex the tax, the better. The goal under the corporate tax should be to apply its rate as uniformly as possible to all business net income. Departures from this uniformity will have the effect of pushing resources into the favored areas. We should at all times be aware of these departures and the revenue costs involved, so that we can determine whether the resulting allocation of resources is in the direction we want and, if so, it is being achieved effectively with the least expenditure of Federal funds. For, as has been pointed out many times, revenues lost through tax preferences for certain activities are expenditures which should at least meet all the tests applied to direct budget expenditures.

Departures from Uniformity

We can approach the question of the extent and nature of departures from uniformity under the corporate income tax through an examination of effective tax rates. The corporate income tax can generally be regarded as requiring corporations to pay tax at a 48% rate (apart from the 10% surcharge) on their total net income as net income is usually defined for business purposes. This is what would happen if there were no surtax exemption (under which the first $25,000 of income is taxed at 22%), no investment credit, no special capital gain rate, and no special deductions or exclusions. Without these items, the effective rate under the corporate tax would be 48%. The actual effective rate for all industries on total net income, however, is only 37.5%. The question is, therefore, what factors reduce the actual effective rate from 48% to 37.5%?

Looking at all industries together, if we consider only the effect of the surtax exemption and the investment credit -- matters of general application -- the expected effective rate would be lowered to 43.4%. For manufacturing, generally, the expected effective rate would be 44.9%. The actual effective

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rate on total income for manufacturing is 43.3%. This is so close to the expected rate of 44.9% that, as a general proposition, we can say that the tax applies with reasonable uniformity to manufacturing activities. The cause of the reduction from the expected rate of 43.4% for all industries to the actual rate of 37.5% must, therefore, lie in lower effective rates on certain types of activity. The data show this to be the situation.

The effective rates for those activities that vary most significantly from their expected rates are:

	Expected Effective Rate	Actual Effective Rate
Natural Resources		
Petroleum	44.8%	21.1%
Other Mineral Industries	42.7%	24.3%
Lumber	41.2%	29.5%
Financial Institutions		
Commercial Banks	43.4%	24.4%
Mutual Savings Banks	42.4%	5.3%
Savings & Loan Associations	40.4%	14.5%

The major aspects of unevenness of the corporate tax are thus primarily a matter of the tax preferences applicable to two industries -- natural resources and financial institutions.

House Bill Solutions

Financial Institutions. The House Bill takes important steps in cutting back on the tax preferences accorded financial institutions. It would eliminate the existing excessively generous and artificial bad debt reserve granted by Internal Revenue Service rulings to commercial banks and instead apply the rule of actual experience, which governs all other business activities. It would also eliminate the present treatment of the losses of banks on bond sales as ordinary losses while the gains are regarded as capital gains, by making both losses and gains ordinary in character.

The Bill, however, still permits commercial banks to have full exemption from tax of the interest on state and local bonds while also allowing full deduction of the expenses involved in obtaining that interest. The retention of this tax preference will permit commercial banks still to enjoy tax rates below those applicable to business generally.

There is no persuasive reason why commercial banking should have a lower tax rate than other business activities. Certainly the arguments of banks that they must have excessive bad debt reserves to meet a possible serious decline in the economy are without merit. Their pessimistic outlook for the future should not be rewarded by tax favoritism. There are mechanisms at hand to allow full scope to that pessimism without its providing tax benefits for bank shareholders year after year. Thus the Bill provides a ten-year carryback of bad debt losses. The banks say that this is not a current asset for financial purposes. The answer then for this problem is to use the provision Congress adopted in 1967 to solve a similar assertion by the mortgage reinsurance companies (Code Section 832(e)). The present law here allows the deduction of a larger reserve than experience would dictate but requires that the tax benefit of that deduction be invested in special Federal Government "tax and loss" bonds that are non-interest bearing. These bonds would be redeemable and the reserve restored to income in ten years and then taxed (unless it were earlier required to use the reserve). In this fashion, an asset -- the Government bond -- is available as an asset on the balance sheet to meet the pessimistic possibilities seen in the future, but that pessimism is not rewarded with a tax benefit.

The Bill reduces the over generous and artificial statutory bad debt reserve deductions accorded to mutual savings banks and savings and loan associations, though leaving the deductions higher than those permitted commercial banks. It gears these higher deductions to investments in certain types of assets, principally residential real estate. Here it unduly favors mutual savings banks through a lower investment requirement (72%)

-- the difference in treatment is not justified and the mutual savings banks should be placed at the level of the savings and loan associations (82%). Moreover, it would be appropriate for tax purposes to place both institutions on the same bad debt actual experience reserve approach applied in the House Bill to commercial banks. Studies in 1961 showed this to be the proper course. Any requirements as to investment could then be handled in non-tax legislation. And any assistance deemed needed for residential and multi-unit housing could equally be handled through the non-tax measures.

The Treasury recommends that all these institutions should equally be limited to a bad debt reserve based on actual experience. But it couples its suggestion with a recommendation for a special deduction of 5% of the gross income obtained from certain loans, including residential real property loans and student loans. Here also, this resort to special tax incentives for special purposes is unwise. If these loans are to be assisted by Government funds, it should be done outright - as in the example of student loans where the Government directly meets part of the interest cost. (Any aspect of high risk on certain loans is adequately met through a bad debt reserve based on actual experience). The Treasury recommendation is really the start of a percentage depletion system for financial institutions and has all the potentiality for the development that has marked such an approach in the natural resources area.*

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* There are other problems with the proposal. Thus, it would mean both lower taxes and less assistance to housing in the use of the savings and loan associations. It would also permit stock savings and loan associations to pay out the tax benefits to their shareholders, which is not permitted today in the case of the artificial bad debt reserve deductions. Also, the amount of the deduction -- and hence the assistance to the borrower -- depends on the extent to which the institution has certain tax shelters, such as tax exempt bonds. But if the borrower needs assistance, why should he be denied the assistance because the bank has a tax shelter -- it is a curious system that would deny a needy student a loan because the bank has bought tax-exempt securities. Of course, tax equity explains the connection. But the result underscores the undesirability of resorting to the tax system at all as a mechanism to assist borrowers.

Natural Resources. In the natural resources area the House Bill reduces by about 25% the present rates of percentage depletion. It eliminates the tax abuses possible through the use of mineral production payments and ABC transactions. It tightens the rules applicable to mining exploration expenditures. It does not, however, change the present liberal treatment of intangible drilling expenses for oil and gas wells. And it does not deal with the capital gains tax preferences granted to timber, except as it increases the capital gain rate generally for corporations from 25% to 30%.

This Committee has before it the results of a study prepared for the Treasury Department, the Consad study, relating to the effectiveness of the present tax treatment for oil and gas. One would suspect that the results of that study -- which concludes that the present tax mechanism for assistance to these activities, if assistance is needed, is quite wasteful -- would be duplicated in the case of the percentage depletion accorded to other minerals.

The Treasury recommends a recapture rule on the transfer of an oil or gas well under which any gain on the transfer would be ordinary income to the extent of intangible drilling expenses previously deducted, and this recommendation is appropriate. It also disagrees with the provision in the House Bill extending the cut-off point for percentage depletion on oil shale to include non-mining process. This disagreement is well taken. Tax history has shown that persistent efforts to extend the cut-off points for the various minerals receiving percentage depletion have been quietly effective in amplifying the depletion advantage, and often more effective than any likely upward change in the depletion rates themselves. A Treasury report to this Committee on the varying cut-off points applicable today, and the differences in value (to which the depletion rates apply) between those points and cut-off points more consistent with an effort to stop at the mine would be quite constructive.

The Bill changes the rules applicable to the treatment of foreign minerals, some of the changes occuring through changes in the foreign tax credit rules. The thrust of the changes is

to insure that U. S. companies do not, through deductions for the development of mineral interests abroad and through excess foreign tax credits arising in the foreign mineral operations, reduce the U. S. tax on their U. S. income or the U. S. tax appropriate to other foreign income. The Treasury has suggested improvements in the foreign tax credit provision, which would make the determination of the excess credit turn on the effect of the availability of the depletion deduction under U. S. law.*

Multiple Corporations. The House Bill would end, over an eight year transition period, the present tax favoritism granted to those businesses which operate through the use of multiple corporations rather than a single corporate unit. The result is sound, and long delayed. Whatever may be the reason why a business chooses to use multiple corporations, be it tradition, business reasons, state laws, or pure tax avoidance, there is no tax justification for providing it with a lower tax than an enterprise with similar total income but fewer corporate units. The efforts to rationalize this tax preference, which efforts often are a tribute to the imagination and resourcefulness of the legal and accounting professions, have over the years reached new heights in the defense of this provision -- a provision which in reality has no sound argument for it at all. One would think the beneficiaries of the provision would feel grateful that it has been kept alive so long. Moreover, the House Bill is exceedingly generous in allowing a phase-in of the intercorporate dividend deduction and pre-consolidated return loss benefits during the phase-out of the multiple corporation benefit; it would be more appropriate to deny these benefits until the multiple corporation benefits end.

New Tax Incentives. When one looks at the House Bill overall, one sees that most of the reform efforts are directed at reducing

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* These recommendations are similar to those made by the Treasury in 1963. The Treasury in its suggestion does not include the availability of the deduction for intangible drilling expenses or other development costs in the determination of the excess credit. It would seem this should be covered, unless the interplay with the recapture provision applicable to such expenditures provides sufficient protection.

the impact of the various tax incentives that have entered our tax law gradually over time, either through statutory provision or administrative action. There are relatively few provisions in the Bill directed at remedying mistakes in tax structure, that is mistakes in which there was no intention deliberately to confer a tax benefit for incentive or other reasons but rather matters in which the technical tax structure just didn't work correctly. Examples in the Bill of such structural repair are the corrective rules applicable to multiple corporations, accumulation trusts and multiple trusts, mineral production payments, restricted stock, tax free dividends, deferred compensation and stock dividends.

The major part of the Bill, in substantive scope and revenue impact, relates to tax provisions which, whatever their origins, are supported by their adherents on tax incentive grounds. The fact that the task of tax reform today really consists of a scaling-back of all these tax incentive provisions -- because of their ineffectiveness, their waste of Government resources, their misallocation of Government resources, and their effect on tax equity -- is underscored by the House Bill. Its major provisions relate to existing tax incentives for real estate, financial institutions, natural resources, investment, state and local government assistance, farm activities, and so on. These Senate Finance Committee Hearings indicate that once a tax incentive takes root in the tax law it is a very difficult matter to restrict or eliminate it, especially if it has the protective coloration of being cast in a traditional jargon and structure indistinguishable to most persons from the jargon and structure that mark most of our Internal Revenue Code.

All this being so, it is indeed unfortunate that the House Bill opens up three new tax incentives, and that the Treasury would also seek to adopt others. The House Bill provides five-year amortization for pollution control facilities; five-year amortization for rehabilitation expenditures on housing; and seven-year amortization for railroad cars. It appears that "amortization" is now the magic word and we may be witnessing the beginning of a wide schedule of

amortization periods for various businesses and activities akin to the schedule of percentage depletion rates.

The Treasury deplores the railroad car amortization, probably doesn't want the pollution facility amortization and would certainly cut it back in scope, and seems responsible for the rehabilitation amortization. As stated earlier, it would introduce a new type of tax incentive for certain loans by financial institutions.

In all, the House Bill in its amortization incentives has a revenue cost of $830 million. If to this is added the retained excessive depreciation for housing, especially luxury and high cost housing, the Bill involves over $1 billion of tax incentive expenditures. If one is seeking to reduce the net revenue cost of this Bill, these are areas in which one could properly start. If funds of this magnitude are to be spent for social and other programs, they ought to be spent directly as Government expenditures and in accordance with carefully selected priorities in the various programs.

I have previously discussed the weaknesses of the housing rehabilitation provision. The Treasury has described the weaknesses of the railroad car provision. As to the pollution facilities provision, which will cost $400 million, the Treasury has described some of its weaknesses in urging that it be cut back. But more can clearly here be said.

Legislative committees have struggled long and hard to find the most efficient ways to expend Government resources in the battle against pollution. There are many claimants for Government dollars and those concerned about combating pollution have found it difficult to secure the funds they desire. Interested legislators speak of scrounging a few more millions here or there to add to an inadequate Budget figure. Yet now, at one stroke, the Ways and Means Committee decides to spend $400 million (by 1974) in the pollution control area by allowing five-year tax amortization of the cost of installing pollution control facilities. But the Committee does not refer to any study which indicates that -- if the Government is to allocate an additional $400 million to pollution control -- the particular device and particular approach chosen by the Ways and Means Committee would have top priority.

Instead, $400 million is allocated to this purpose without any coordination with other planning or expenditures in the pollution control area and without regard to what are the priority needs once it is decided to add $400 million to pollution control expenditures. It is quite likely that the top priority lies in assistance to municipalities and not to industry.

If these tax incentive provisions are to remain, they should at least have a definite termination date and, as suggested earlier, arrangements made to transfer the funds involved to the direct expenditure programs of the agencies concerned.

Foundations and Tax Exempt Organizations. The House Bill contains extensive changes in the treatment of foundations. A number of the provisions deal with abuses that have been documented earlier by the Treasury Department -- self-dealing; failure to make adequate current distributions; ownership of businesses; utilization of the foundation by the donor as an instrument to facilitate control of a business; and speculative investment of assets. Provisions correcting these abuses are sorely needed. They would be of material assistance in rescuing private foundations from the cloud that now hangs over them.

The financial assistance given foundations through the tax system can be justified only if their sole purpose is to function as genuine philanthropic institutions. If the foundations want to serve other purposes besides philanthropy, then they should not receive that assistance and should not complain if the Congress and the public regard them with unfriendly suspicion. Thus those who urge that foundations are useful institutions to perpetuate family business or to keep particular businesses from being absorbed in merger investments, may perhaps be wisely serving the businesses involved, but they are not wisely serving either the foundation as an institution or the purposes of philanthropy. These purposes of protecting businesses are not the functions of philanthropy. Our colleges and our other charitable institutions do not concern themselves with these non-philanthropic goals. If our foundations wish to merit and fulfill a useful institutional role in our society, they should and can do so only by functioning solely as philanthropic institutions.

For these reasons the House Bill provisions concerning these matters should not be weakened as many are urging. Nor should there be special exceptions for any foundation, such as the provision in the House Bill allowing the Kellogg Foundation to own over 50% of the Kellogg Company.

Other provisions of the House Bill in the foundation area deal with different matters. One, the 7-1/2% tax on investment income, is unadvisable, if the provisions countering abuses are strong enough to insure that foundations are functioning solely as philanthropic institutions. If it is determined that there should be a modest fee to meet the cost of administration, it should be based either on asset value or income distribution (including the 5% minimum) -- to use only net investment income would favor the foundation that invests in non-income producing assets.

Other provisions deal with the operational activities of foundations and are designed to maintain a philanthropic posture as contrasted with political activities, lobbying activities and the like. These provisions require careful articulation and drafting lest the pursuit of the goals involved, which in general purpose are appropriate, does not in the day-to-day operation of the provisions hamper the basic philanthropic functions of these institutions.

The provisions in the House Bill relating to other tax-exempt organization problems, such as the strengthening of the unrelated business income tax and the taxing of the investment income of social, fraternal and similar organizations, are all improvements.

Summary as to Corporate Tax

The House Bill is a significant step forward in beginning to meet the problems of tax reform under the corporate tax:

-- With respect to the industries with the present lowest effective rates:

-- As to financial institutions, the Bill brings the effective tax rates of the commercial banks, mutual savings banks and savings and loan associations

closer to those paid by business generally, and also reduces the range differences within these institutions themselves.

-- As to natural resources, the Bill reduces the percentage depletion rates by about 25% and ends the abuses associated with mineral production payments. But it fails to deal with the aspect of intangible drilling expenses in the oil industry and the tax preference accorded to timber.

With respect to other preferences:

-- The Bill ends the tax escape now provided for multiple corporations.

-- The Bill cuts back on the tax preferences accorded to real estate.

-- The Bill strengthens the rules governing foundations and other tax-exempt organizations.

But the Bill has a serious weakness in the addition of new tax incentives:

-- The five-year amortization for pollution control facilities.

-- The five-year amortization for housing rehabilitation expenditures.

-- The seven-year amortization for railroad cars.

A Word on Pessimism and Tax Benefits

There is no one so pessimistic about the future of the country as an industry or taxpayer faced with losing a tax preference. These Hearings seem replete with industries and taxpayers who can see only gloom ahead. The correlation between pessimism and tax benefits is indeed high, for these prophets of gloom assert that their pessimism for the future should be reflected in continued or increased tax preferences.

Thus, the Stock Exchange sees a pessimistic future for investment and asserts that its pessimism be met by keeping the preferences unchanged for capital gains. The financial institutions are pessimistic about a possible depression and therefore seek higher bad debt reserves -- and higher tax benefits -- to match that

pessimism. The mutual savings banks and savings and loan associations are pessimistic about the future of housing and seek tax benefits that reflect that pessimism. Wealthy non-farmers worry about the future for cattle and horses and orchards, and seek to retain farm "tax loss" shelters to house their pessimism. The natural resources industry is alternatively pessimistic about national security and the price consumers of gasoline will have to pay, and seeks tax benefits to dispel that pessimism. And so it goes as to almost every provision in the House Bill, even as to the "small businesses" housed in the multiple corporations of an enormous multi-state enterprise.

Most of the pessimism is self-assertion, for there are few studies, if any, that document the beliefs. No one wants to see if his view of the future is wrong, for that course means the loss of tax preferences. All would prefer to be gloomier, for that course could mean increased benefits if their view of the tax system is accepted. For all see the tax system as a device to pour out financial assistance to industries and activities that do not want to trust to the marketplace. The accent is not on private enterprise, but on private enterprise plus tax assistance. None is willing to pull back on the preferences so we can see if the pessimism is really warranted and to see if Government assistance is really needed. And then, if the assistance is really needed, to see it provided through direct expenditure programs.

It should be clear by now that this tax incentive rationalization, this infusion now of social goals into tax provisions adopted long ago without any thought of incentive or social programs or the like, can only be destructive of an equitable tax system and an efficient use of Government resources. It is the proper course now to cut back these tax incentives and await the future. The House Bill is a good start and should be pushed forward, not stripped back.

Rates of Tax and Revenue Cost

My principal purpose is to discuss the structural tax reform provisions of the House Bill and hence I wish to say only a few

words regarding the rate structure.

As stated earlier, those first in line for tax relief when reduction is considered feasible, are the low-income taxpayers. Those next in line are the middle-income taxpayers not itemizing deductions for personal expenses. The House Bill fully meets these two claims for relief. It then goes on to reduce tax rates throughout the rate schedule. The result is a total long-run revenue loss of $2.4 billion.

Looking ahead to 1979, such a loss is hardly significant, considering the hazards of revenue estimates. In all likelihood such a tax reform bill cannot provide a net revenue gain, even though an appraisal of national priorities would put more emphasis on expenditure programs than such a large tax reduction. The House Bill before the last round of tax reduction added after the Bill was reported, was in this respect a better balanced bill -- from the expenditure-tax reduction aspect -- than the Bill as it finally passed the House. And even the Committee Bill could be regarded as too generous in some of its rate reduction in the brackets above the middle. But aside from these thoughts, the margin for concern about the revenue aspects, i.e. the $2.4 billion loss in 1979 considered as an absolute matter, is small. The Treasury appears to recognize this, for its changes would leave a revenue loss of $1.3 billion -- the difference of $1 billion is hardly cause for major economic judgments.

The important matter is the composition of the tax reductions. The Treasury approach to the House Bill, as described earlier, is to make the across-the-board individual reduction paramount and then to strip back the relief for low and middle income families.*

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* The House Bill has a considerable revenue loss -- $650 million -- through a change in the treatment of single persons. I would not give this matter such a high priority, especially since the relief for lower and middle-income taxpayers will to a very large extent meet the problems of single persons in these brackets. If we are to give further relief to single persons, the Treasury suggestion in this area is an improvement over the House Bill.

As a consequence, the tax liability reduction under the Treasury approach shows a large reduction in the $0 - $3000 bracket and then proceeds to a relatively flat decline from $5000 on to $100,000. In contrast, the House Bill shows significantly larger reductions up to the $20,000 bracket than the Treasury approach, and the slope of the tax reduction is far from flat. There is no question but that the House Bill has a fairer distribution of the tax reduction.

The Treasury approach, after cutting back the reductions in the low and middle-income brackets, is then to use the revenue so obtained to reduce the corporate tax rate by two points. Such a change is not defensible on tax equity grounds or on economic stabilization grounds. The Treasury desire to remove the investment credit was based on the ground that capital formation was at a high level now and no general investment incentive was needed. From a stabilization standpoint there is no point in substituting a corporate rate reduction for the investment credit.

As to future growth and the relative balance between consumption and investment, we can afford to wait a bit until the present inflationary pace really wears away to see if capital formation will then lag. If it does, a resort again to an investment credit can be more meaningful than corporate rate reduction. There is no point now in choosing weaker devices on the assumption that capital formation may later need strengthening.

One could point out that if the various new tax incentive devices in the Bill are not to be scrapped in favor of a resort to direct expenditures in the areas involved, then a preferable course is to drop those devices and use the revenue to lower the corporate rate. Such a step, together with a further cut-back of accelerated depreciation for real estate and more tightening of the remaining corporate tax preferences, would readily produce the revenue to support two-point reduction in the corporate rate.

Conclusion

The Ways and Means Committee and the House have taken a significant step forward to the goal of a fairer and simpler Federal income tax. It is now up to this Committee and the

Senate to make that step a decisive one. The House Bill is a fine structure to build upon. It can be strengthened in a number of ways and these weaknesses should be corrected. But its many, many strengths should be retained.

STATEMENT OF DAVID N. MILLS IN OPPOSITION
TO SECTION 302 (ALLOCATION OF DEDUCTIONS)
OF H. R. 13270 (TAX REFORM BILL OF 1969)

SUMMARY OF PRINCIPAL POINTS

1. Since most of the "tax preference" items to which Section 302 would apply do not represent cash or property received by the taxpayer during the year, they cannot be regarded as the source from which any personal deductions could have been paid.

2. Personal deductions should not be disallowed except to the extent actually attributable to tax exempt income or preferences.

3. If the tax preferences in question should be eliminated or reduced, this should be done by directly taxing the same rather than by using such preferences as the basis for disallowing wholly unrelated and legitimate deductions.

4. Section 302 discriminates between different classes of taxpayers (a) by applying to individuals but not to corporations with the same types of deductions, and (b) by applying unequally to taxpayers allowed the same aggregate amount of depreciation (or its equivalent) during the life of the same property.

5. Section 302 would have a serious adverse effect on charitable and educational institutions dependent primarily for their support on medium and large-sized gifts from individuals who measure their ability to give or the amount of their gifts by the "after-tax" cost of such giving.

6. The allocation of deductions called for by Section 302 would unnecessarily complicate the tax law and the tax return forms.

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or failure to capitalize capital expenditures, (b) intangible drilling expenses and percentage depletion to the extent that they exceed what would have been allowed if a taxpayer had capitalized such expenses and recovered the same by cost depletion and depreciation, and (c) accelerated depreciation of buildings to the extent that it exceeds straight line depreciation. Depreciation, acquisition of farm inventory or capital assets, and intangible drilling expenses never represent dollars or income received (taxable or exempt) but rather represent money paid out or spent (though in the case of depreciation it may have been paid out in a prior year). One might well argue that such payments should be treated as capital expenses (to be deducted gradually over the years by way of depreciation or depletion rather than all at once when incurred) but to prevent part of them from ever being deducted at all at any time would be grossly unfair. In any event it is clear that to the extent that during the year a taxpayer spends money on intangible drilling costs of oil and gas wells (or buys a depreciable asset for his farm not required to be capitalized under his method of accounting) resulting in a deduction of such costs in full when spent, he receives no net cash realization from such expenditure such as might be regarded even in part as the source of any of his payments resulting in personal deductions.

2. PERSONAL DEDUCTIONS SHOULD NOT BE DISALLOWED EXCEPT TO THE EXTENT ACTUALLY ATTRIBUTABLE TO TAX EXEMPT INCOME OR PREFERENCES.

Certainly nobody can fairly object to denying a personal deduction for any expenditure actually attributable to or incurred in the production of tax-exempt income or preferences. The existing law already recognizes this, however, and denies, for example, a deduction of interest paid on money borrowed to pay the premium on a single premium annuity or insurance policy (IRC Section 264), interest paid on any debt incurred or continued to acquire tax-exempt state or municipal bonds (IRC Section 265(2)), and expenses incurred in the production of tax-free income (IRC Section 265(1)), such as trustee's fees and other investment expenses attributable to tax-exempt state or municipal bonds. If there are other examples of personal deductions which may with any frequency be in fact attributable to the receipt of tax-exempt income or tax preferences (though I believe there are none), then IRS Sections 264 and 265 should be expanded to deny such deductions. But where the payments giving rise to personal deductions are not in fact attributable to any item of exempt income or tax preference (as is, in the nature of things, never the case with respect, for example, to the payment of a medical or dental expense) there can be no reason at all for making an arbitrary assumption to the contrary, on a pro-rata basis or otherwise, by constructively attributing or ascribing a portion of all personal deductions to exempt income or tax preferences. After all, the inherent nature of personal deductions is such that in an economic sense they are almost never traceable or related in any way to exempt income or preferences. Thus they become "personal" deductions by virtue of not being business-related.

The proponents of Section 302 may reply that even if a personal deduction cannot be identified as being attributable to or incurred in connection with the production of exempt income, it may still in economic effect be deemed pro-rata to have been paid out of such exempt income. This "source-of-payment" argument and its arbitrary pro-rata approach is, I submit, wholly fallacious. Thus a change might logically be made in the law to provide that personal deductions are only to be allowed to the extent that they are paid out of taxable income, but Section 302 is not predicated on that rationale. Thus payments made out of capital or principal (as opposed to exempt income or tax preferences) would of course remain allowable as personal deductions notwithstanding Section 302.

For example, if in a given year a taxpayer has $50,000 of ordinary income and sells capital assets for $40,000 resulting in $25,000 of long term capital gain (since the property cost him only $15,000 many years earlier), I fail to see why he should have any more charitable contributions and other personal deductions disallowed than an identical taxpayer with the same $50,000 of ordinary income but whose sale of the same property for the same $40,000 resulted in no capital gain (since his original cost was $40,000 or more). It may be perfectly true that in both cases the proceeds of sale of a capital asset may be said at least theoretically to constitute the source or subject matter of a pro rata part of the payment of a charitable contribution or other personal deduction, but what possible reason can there be for making the availability and amount of the deduction depend on the matter of how much of such sale proceeds happen to constitute capital gain rather than a return of capital costs?

It may be further noted that since personal deductions (unlike net operating losses) cannot be carried forward or backward to a different year (with a minor exception as to charitable deductions), no tax benefit can ever be had from any personal deduction in excess of what otherwise would be the taxpayer's taxable income for the year. That is to say, even under the present law personal deductions are in effect not allowable unless they at least could have been made from taxable (as opposed to tax-exempt) income.

The theoretical pro-rata source of payment approach of Section 302 also ignores the situation often prevailing as to personal deductions that are specifically attributable to or paid out of identifiable items of taxable income; for example, interest on money borrowed for the specific purpose of investing in (taxable) interest or dividend producing assets, or property taxes or mortgage interest paid on rental property held as an investment. Such interest and taxes, though incurred in connection with the maintenance of property held for the production of income (and not constituting purely personal expenses) would of course be allowed to an individual only as personal deductions if not incurred in a "trade or business". But Section 302 makes no provision for excluding such identifiable personal deductions from the items subject to the artificial proration called for by that section.

3. IF THE TAX PREFERENCES IN QUESTION SHOULD BE ELIMINATED OR REDUCED, THIS SHOULD BE DONE BY DIRECTLY TAXING THE SAME RATHER THAN BY USING SUCH PREFERENCES AS THE BASIS FOR DISALLOWING WHOLLY UNRELATED AND LEGITIMATE DEDUCTIONS.

If a taxpayer who has tax-exempt income or preferences should as a policy matter be required to pay additional income taxes as a result of same, this should be provided for either by eliminating the tax exemption feature or preference or a portion thereof directly (such as the House Bill has already done by narrowing the definition of long term capital gains and removing the 25% tax ceiling on same) or by directly taxing otherwise exempt income at some lower rate,-and not by the "back-door" method of penalizing the recipients of such income or preferences by disallowing perfectly legitimate deductions (for charitable contributions, interest and taxes paid, medical and dental expenses, etc.) which are allowed in full to other taxpayers who don't happen to also have that particular type of preferential income. Direct taxation of exempt income or direct disallowance of a deduction of tax preferences would also have the advantage of treating in identical fashion different taxpayers with the same amount of exempt income or tax preferences, whereas the Section 302 approach differentiates between them by making the amount of the (indirect) tax on such exempt income or preferences depend instead on the amount of the taxpayer's personal deductions. I submit that if two taxpayers, one using the standard deduction and the other having substantial itemized personal deductions, have an identical amount of taxable income and also an identical amount of exempt income and preferences, there is no reason why one of them should pay no additional tax on such exempt income and preferences (because of using the standard deduction in lieu of itemizing his personal deductions) whereas the other one must pay a substantial tax penalty as a result of having such exempt income or tax preferences.

If only such a direct approach could be employed, I am confident that Congress would, for example, not even consider taxing interest received on state or municipal bonds heretofore issued and which were bought at a price and with an interest rate entirely predicated on the assumption of their being exempt. Many also question whether Congress could constitutionally do so. I submit that if it would be unfair to tax directly such state or municipal bond interest, it would be even more unfair to attempt to tax it through the indirect method prescribed by Section 302. Furthermore, the uncertain, unequal and unmeasurable effect of Section 302 on different taxpayers (or on the same taxpayer in different years, depending on the varying amount of his personal deductions) might seriously disrupt or disturb the municipal bond market and thus substantially increase the future cost of state and municipal borrowing.

4. SECTION 302 DISCRIMINATES BETWEEN DIFFERENT CLASSES OF TAXPAYERS (A) BY APPLYING TO INDIVIDUALS BUT NOT TO CORPORATIONS WITH THE SAME TYPES OF DEDUCTIONS, AND (B) BY APPLYING UNEQUALLY TO TAXPAYERS ALLOWED THE SAME AGGREGATE AMOUNT OF DEPRECIATION DURING THE LIFE OF THE SAME PROPERTY.

Section 302 is worded so as not to apply to corporations. Thus under the House Bill a corporation would continue to be entitled

to deductions for all charitable contributions paid (subject only to the applicable percentage of income limitations), all interest paid, and all property, sales, gasoline, state and local income taxes paid,-even though unrelated to its trade or business and therefore constituting items which an individual could only take as "personal" deductions. The fact that such corporation also has exempt income or tax preferences of the type to which Section 302 applies will not cause it to be deprived under Section 302 of any part of its deductions for charitable contributions, interest and taxes paid.

Other forms of discrimination as between otherwise identical taxpayers would also result from Section 302. For example, accelerated depreciation of buildings in excess of straight line depreciation in any year is treated as a tax preference requiring allocation of personal deductions under Section 302. However, accelerated depreciation in a given year can only mean that in certain subsequent years during the life of the depreciable asset in question the taxpayer's depreciation will be less than what would have been allowed if the asset had been depreciated on a straight line basis throughout its life. But Section 302 proposes no adjustment in any subsequent year to allow for such "reverse preference", even though it in effect constitutes in economic effect a partial repayment of a preceding year's tax preference. Thus two identically situated taxpayers, one using the sum-of-the digits method of depreciation and the other using the straight line method, will each have the same amount of aggregate depreciation deductions during the full life of a given asset. Yet the one using the sum-of-the-digits method will be required to make a Section 302 adjustment on account of the same during certain years while the one using the straight line method will never be required to make any Section 302 allocation on account thereof. Similar examples of unequal treatment of identical taxpayers could be demonstrated for the Section 302 adjustments called for as a result of failure to capitalize intangible drilling costs and certain farm expenses.

5. SECTION 302 WOULD HAVE A SERIOUS ADVERSE EFFECT ON CHARITABLE AND EDUCATIONAL INSTITUTIONS DEPENDENT PRIMARILY FOR THEIR SUPPORT ON MEDIUM AND LARGE-SIZED GIFTS FROM INDIVIDUALS WHO MEASURE THEIR ABILITY TO GIVE OR THE AMOUNT OF THEIR GIFTS BY THE "AFTER-TAX" COST OF SUCH GIVING.

While other types of personal deductions represent for the most part involuntary payments and the amount thereof should accordingly not be appreciably affected by the enactment into law of Section 302, charitable contributions on the other hand are in their very nature voluntary. An independent school which I represent advises me that well over 90% of the dollar value of all gifts to it consists of gifts of $100 or more each. The amount of charitable giving by most donors above approximately the $100 level depends in large part on the tax effect of such giving. Recognition of this fact and the impact of same on hospitals, private colleges, universities, etc. resulted in the House's narrowing the scope of Section 201 (c) and (d) of H.R. 13270 (taxing the unrealized gain from appreciated property given to charitable organizations) to the point where it will only apply to a very small percentage of such contributions. But the House then proceeded to do under

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Section 302 what it was unable or unwilling to accomplish under Section 201 (c) and (d), by partially disallowing the charitable deductions in question in all cases where such unrealized appreciation (plus other forms of exempt income and preferences described in Section 302) exceeds $10,000. Certainly one result that could be fairly anticipated from the enactment of Section 302 into law would be for the many individuals whose substantial charitable donations in the past have invariably taken the form of gifts in kind of appreciated property to simply stop making large charitable gifts. I believe a previous witness at these hearings has testified to the effect that 55% of the dollar value of all gifts to a group of Massachusetts colleges are so made in kind rather than in cash. Undoubtedly cash gifts by foundations and charitable trusts made from the proceeds of sale of gifts in kind made to them by their own donors comprise a very substantial portion of the other 44%.

As applied to charitable gifts of appreciated property Section 302 provides in effect for a double penalty. Thus not only is the unrealized appreciation itself treated as one of the tax preference items requiring Section 302 allocation; but in addition such appreciation also represents part of a charitable gift which constitutes one of the personal deduction items subject to such Section 302 allocation. I would assume that it is for the above reasons that the administration has recommended narrowing the scope of Section 302 by removing unrealized appreciation from charitable gifts in kind from the list of tax preferences subject thereto.

6. THE ALLOCATION OF DEDUCTIONS CALLED FOR BY SECTION 302 WOULD UNNECESSARILY COMPLICATE THE TAX LAW AND THE TAX RETURN FORMS.

The adjustments called for by Section 302 would apply in every year to hundreds of thousands of taxpayers who would have to bear the time-consuming burden of making the many calculations called for by that Section, nearly all of which apart from Section 302 would never even have to be computed by the taxpayer (except as to some such items in the extremely rare instances covered by Section 301).

The necessary additional computations and record-keeping required under Section 302 with respect to intangible drilling expenses, straight line depreciation, cost depletion and the keeping of a separate set of farm books using the inventory method of accounting (including the taking of a beginning inventory each year) would be most complex. As an example, in order to calculate for a given year the amount of his accelerated depreciation in excess of straight line depreciation (or, in the case of oil and gas wells and farm losses, the amount of depreciation which would have been allowed if the taxpayer had capitalized intangible drilling expenses and certain farm expenses), the taxpayer will have to make a separate determination of the salvage value of each item (a determination which is not necessary under the 200% declining balance method of depreciation) and if there has at any time been a change in useful life, he will have to recalculate straight line depreciation on a year-by-year basis from the time of his original acquisition of

the property in question. Similarly with respect to determining percentage depreciation in excess of cost depletion, he will have to make a determination, from information not generally available, of the amount (in barrels of oil and cubic feet of gas) of oil and gas extracted and sold during the year and also of his oil and gas reserves in place at the beginning of the tax year. In order to determine reserves in place for cost depletion purposes, he must obtain a reasonably up-to-date engineering report, which will not normally be available unless he goes to the expense of having one made for this specific purpose.

In short, then, Section 302 would be an administrative headache, require a number of exceedingly complex computations and tax return entries (never heretofore required) to be made by a large number of taxpayers, entail additional work by the IRS in auditing, checking and reviewing such additional computations and the evidence necessary to verify the figures used in such computations, and be a step in the opposite direction of the objective of tax and reporting simplification which so much of the rest of the House Bill (particularly its proposed increase in the standard deduction) was so wisely designed to accomplish and which the taxpayers themselves are so vociferously demanding.

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September 19, 1969

AIR MAIL

SPECIAL DELIVERY

Senate Finance Committee
Room 2227 New Senate Office Building
Washington, D.C. 20510

Comments Upon Proposed Taxation of Interest on Municipal Bonds Under The Tax Reform Bill of 1969 (H.R. 13270)

Gentlemen:

SUMMARY

Serious questions exist as to the validity under the Federal Constitution of certain provisions of The Tax Reform Bill of 1969 (H.R. 13270), specifically:

(a) the "Limit on Tax Preference" (LTP) provisions in section 301 imposing a direct Federal income tax on municipal bond interest.

(b) the "allocation of deductions" provisions in section 302 imposing an indirect Federal income tax on such income by the reduction of other deductions merely because of the receipt of such income by a taxpayer, and

(c) the Federal subsidy and waiver of tax exemption provisions in sections 601 and 602 in their application to the political subdivisions of any state in the absence of its authorization of action pertaining thereto by its political subdivisions at least by state act or possibly by state constitutional amendment.

GENERAL COMMENT

I am appearing before this Committee in order to present the views of members of several law firms which are nationally recognized as municipal bond counsel with regard to the tax reform proposals presently before this Committee as they relate to treatment of the interest on obligations of states and their political subdivisions (herein "municipal bonds" and collectively "Local Governments," respectively). My statement is directed primarily at setting forth our views on the constitutionality of any attempt to impose a Federal tax directly or indirectly on income on municipal bonds under the "Limit on Tax Preference" (LTP) provision in section 301 of The Tax Reform Bill of 1969, i.e., H.R. 13270 (herein the "Bill"), constituting a direct tax on such income, and the "allocation of deductions" provision in section 302 of the Bill, constituting an indirect tax on such income. While others have expressed their opinion that any attempt to tax such interest would raise a serious constitutional question, this view has apparently not been accorded much weight by some members of Congress. We wish to dispel here any notion that passage of the proposed legislation would meet with no resistance by those who issue and those who invest in municipal bonds. It is the view of our group of bond counsel that a very serious constitutional question is raised by the proposals, both with regard to the right to tax either directly or indirectly the interest on municipal bonds and with regard to the right of a political subdivision within any state to waive the constitutional tax immunity under the waiver and Federal subsidy provisions in sections 601 and 602 of the Bill, in the absence of the state's authorization of action pertaining thereto by the political subdivision at least by state act or possibly by state constitutional amendment.

Under the Federal Constitution neither the Federal Government nor the Local Governments can materially impair the other's power to raise money by borrowing (or by taxation, a point here irrelevant), i.e., materially impair the so-called "sovereign power of the purse."

We understand that Secretary Kennedy recently conceded that the LTP provisions in the Bill posed a grave constitutional question, but that he indicated that the allocation of deductions provision did not pose such a question, even though it related in part to municipal bond interest, in view of <u>United States v. Atlas Life Insurance</u>

Company, 381 U.S. 233 (1965). Atlas actually concerned the allocation of tax-exempt municipal bond income to the policy-holders' reserve (which consisted of 85% of the company's income, and which was not taxable) and to the shareholders' portion of income (which consisted of 15% of such income and was subject to taxation), under the Life Insurance Company Income Tax Act of 1959, on the same prorated basis. The company, by investing in a relatively small portion of municipal bonds, could completely avoid Federal income taxes in the absence of such an allocation. The company contended that the formula imposed a constitutionally impermissible tax on municipal bond interest since its tax bill was higher than if it was permitted to assign all of its tax exempt income to the shareholders' portion of income. The U.S. Supreme Court rejected the contention, and indicated that the formula was equitable and the classification was reasonable, and stated that "[a]s the taxpayer displaces taxable income with exempt income, the size of the tax base, and the tax, are reduced" and that "[t]he burden per taxable dollar of taxable gross income does not increase, but remains the same." (381 U.S., at 2[illegible]4.)

In Atlas the Court stated that in National Life Insurance Co. v. United States, 277 U.S. 508 (1928), the "Court ruled that '[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free'" but "that this is not the case under the 1959 Act." (381 U.S., at 244.) While different in form, in substance the Company's contention was the same as that condemned in Denman v. Slayton, 282 U.S. 514 (1931), where the taxpayer attempted to deduct interest on a loan to him for investment in municipal bonds and also to deduct the interest received by him on the bonds.

Under the present Bill there is no factor similar to that in Atlas justifying an allocation formula like that there upheld. Rather section 302 is merely an attempt to subject certain taxpayers to greater burdens upon their taxable property solely because they own some tax exempt municipal bond income.

Further, the LTP provision and the allocation of deductions provision collectively impose a material impediment upon the borrowing power of Local Governments, particularly in view of the recent deterioration of the municipal bond market resulting merely from the consideration by Congress

of the Bill. Probably each such provision alone will constitute such an impediment to borrowing by Local Governments, if the Bill is adopted. (We are unaware of any contention in Atlas that the 1959 Act imposed such an impediment and the decision does not indicate the Court felt that such was the case.)

There is a divergence of opinion on what the outcome of such litigation would be. I am not here today to predict the result of this litigation. My purpose is solely to point out to this Committee that a reputable group of attorneys experienced in this field of law hold the view that the questions presented by the tax reform proposals are so serious as to present questions which will undoubtedly be the subject of long and protracted litigation. As a result, the market for municipal bonds during this period of litigation will continue in the seriously disrupted condition prevailing at this time. This Committee is, no doubt, aware of the view that the doubts raised by the tax reform proposals have been a major source of the problems prevalent in the municipal bond market today. The continued existence of such doubts can only result in the continued disruption of this important market thereby making it increasingly difficult or impossible for necessary public projects to be financed.

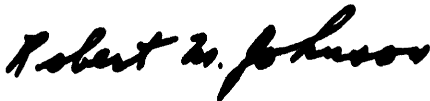
From October 2, 1968, to a recent date (September 4, 1968), The Bond Buyer's 20 Bonds Index rose 2.01% to a historic high of 6.37%, and is about the same now. During the two-month period from July 10 to September 4, 1969, when the money market for corporate securities and U.S. Governments was relatively stable, the same 20 Bonds Index rose about 3/4 of 1% (0.72%), presumably attributable solely to the increasing Congressional threat to tax exemption from a press release of the House Ways and Means Committee and the Bill's introduction and passage by the House.

Predictions as to the length of time needed to settle the various legal questions that will be raised range from a minimum of two years time in the most agreeable circumstances to as long as ten years. As you can see, even the minimum period of time during which the municipal bond market would be disrupted is far too long.

As bond counsel, my colleagues and I are, of course, deeply interested in the proposals presently before this Committee. However, I should like to make clear that regardless of the legislation finally adopted, Local Governments will continue to borrow money, even though at far greater expense than is necessary, and we will, in any event, be called upon to render legal opinions approving such obligations. We are relatively free of any adverse effect from the Bill's adoption and believe our analysis is objective and free from any possible compromise from self-interest. We hope to impress upon this Committee our strong view that the proposals do in fact raise serious constitutional questions, which undoubtedly will be the subject of protracted litigation resulting in a serious distrubance in the conditions of the municipal bond market for a period of up to ten years.

Thank you for your consideration of our views.

Yours truly,



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STATEMENT REGARDING TAX REFORM LEGISLATION: H. R. 13270

Presented to: The Committee on Finance
United States Senate

The Honorable Russell B. Long, Chairman

Submitted by: Richard H. Wangerin, President
American Symphony Orchestra League

On behalf of: The Symphony Orchestras of the United States

September 25, 1969
Washington, D. C.

33-758 O - 69 -- No. 11 -- 8

SUMMARY - EIGHT POINT SUMMARY OF STATEMENT PRESENTED TO THE SENATE COMMITTEE ON FINANCE

Re: Tax Reform Legislation (H. R. 13270)

By: Richard H. Wangerin, President, American Symphony Orchestra League, appearing on behalf of the symphony orchestras of the United States

Date: September 25, 1969

I. Symphony orchestras are vital to the total cultural and educational life of the American people and thus merit the concern of this Committee.

The 1,400 U. S. symphony orchestras play approximately 11,000 concerts a year before audiences totalling 20 million men, women and children (plus radio and TV audiences of uncounted millions), including 3,500 concerts for children and hundreds of free concerts in public parks and civic auditoriums.

II. The basic economic structure of U. S. symphony orchestras requires the subsidy of charitable giving for the orchestras' very existence.

A. Orchestras face the same spiralling costs faced by all other enterprises but orchestras cannot offset these costs through modern production methods.

B. Today, costs of the 1,400 U. S. symphony orchestras total $85 million a year. They earn approximately $41 million as compared to $16 million six years ago, but these earnings represent only 48% of their total costs. They must develop $44 million a year in contributed income.

C. In this country, financial subsidies for orchestras have come traditionally from voluntary contributions. In other countries, the subsidies come from governments.

D. Should private support of U. S. orchestras be reduced, the orchestras would have to seek massive aid direct from government sources or abandon operations.

III. The Treasury Department reports that "taking all proposed tax changes into account that there will be a revenue increase to the Treasury in the charitable contribution area in the neighborhood of $100 million."

If this $100 million is channeled into tax revenues instead of to philanthropic causes, then obviously something constructive must be done to offset the financial loss to philanthropic endeavors in this country.

IV. Proposals of H. R. 13270 would serve to reduce affluent individuals' ability to contribute to orchestras.

A. The proposals of H. R. 13270 would reduce affluent donors' financial ability to give away money as a result of repeal of the unlimited deduction, changed tax treatment of gifts of appreciated property, and gifts of use of property, and proposed changes in many aspects of the more sophisticated types of giving.

B. We, therefore, heartily support the Administration's recommendation to delete the appreciation element of charitable gifts from the "limit on tax preferences" and "the allocation of deductions".

C. We approve Treasury's position that gifts of tangible personal property should continue to be allowed the same preferential treatment as gifts of securities and real property would be afforded under the Bill. Similar treatment should be extended to gifts of future interest.

D. However, this still would leave charitable contributions as an item of deduction subject to allocation of deductions provision. This would have the effect, we fear, of postponing many substantial gifts until the end of a year when the effects of the complex allocation provision could be finally determined, with the unfortunate result that many such gifts simply would not be made.

E. We see no reason why gifts of appreciated property to public charities should remain subject to the present 30% limitation rather than counting toward the extra 20% to be allowed under the Bill for gifts of cash to "publicly supported" organizations.

V. <u>The proposal to increase the standard deduction would serve to reduce contributions the orchestras would receive from persons of more modest income</u>.

A. 88% of the total number of gifts made to symphony orchestras' annual maintenance funds are in amounts of less than $100, averaging $37. These small gifts account for approximately 40% of the total annual contributed dollars received by symphony orchestras.

B. Under the increased standard deduction these contributors, in effect, will receive deduction for charitable contributions whether or not actually made. As a result the orchestras face further shrinkage of contributed support.

C. We strongly urge that charitable deductions be isolated from other personal deductions for separate treatment, and that they be subject to continued itemization with deduction permitted even though the proposed increased standard deduction is used, thereby preserving this crucial incentive for continued support of philanthropic endeavors.

D. If this plan were adopted we would support adoption of a requirement that receipts or cancelled checks be attached to the tax returns to support claims for all contributions over a stated minimal amount.

VI. <u>Certain proposals relating to foundations would serve to reduce this source of support for orchestras</u>.

A. Orchestras are receiving 20% of their contributed support from foundations.

B. We are strenuously opposed to the philosophy of taxing foundation funds for the purpose of adding to the Government's tax revenues.

C. We endorse the Treasury's proposal to substitute for the proposed 7 1/2% tax on foundations, a 2% filing fee and to use this income from the fee to pay for increased policing of the private foundation area by the Internal Revenue Service.

D. It is completely unrealistic to assume that plans to force distribution of foundation assets will result in replacement of losses suffered by tax-exempt organizations as a result of changes in tax treatment of individual charitable contributions

E. We are not opposed to distribution of private foundations' annual income but we are opposed to forced distribution of their capital because such a policy will result in shrinkage of capital funds for future support of charitable organizations. In this proposal we can see only the ultimate liquidation of foundations.

F. In connection with the Bill's provisions on foundations, we want to commend the House on its final action to make it possible for foundations to continue to make grants to individual musicians, conductors, composers, etc. under IRS-approved plans.

III. We are concerned about certain other factors contained in the provisions dealing with definitions of "private foundations" and reporting requirements.

A. We are concerned that the proposed definition of "private foundations" for purposes of the new tax provisions may inadvertently cover many organizations that should not be treated as "private foundations".

1. Under the 1% rule, it is only the amount in excess of 1% that is excluded from qualifying as "public support", whereas the entire amount of the over-$5,000 gift is excluded. We feel that at least the first $5,000 of a large gift should count as a part of an organization's public support.

2. The phrase "any person" is too broad in that it would subject to the 1% rule payments made by government units and public charities. It is ridiculous to exclude any part of public funds from "public" support.

3. Since investment income already is included in total support and more than 1/3 of total support must be derived from gifts, contributions, membership fees, and admissions or other related income in order to qualify the organization as "publicly" supported, there is no reason for having a separate limitation as to the amount of investment income. It serves only to penalize those organizations which have received substantial contributions in the past from generous donors to build up endowment funds.

4. The "organized" test should be changed. It could not have been intended to penalize a trust which now must be operated entirely for charitable purposes simply because, as originally constituted, part of the income was required to be distributed to private annuitants for a term of years or for their lives. It also should be made clear that organizations with defective charters may amend them to satisfy the "organized" test. There is no reason why a separate organization which is operated "in connection with" two or more qualified institutions rather than one such institution, should not be protected under the third exception to the definition of a "private" foundation.

B. We support the provision requiring all tax-exempt organizations to file an annual return, but we challenge the proposed additional requirement that all 501 (c) (3) organizations be required to file listings of major contributors and amounts given, and names and salaries of highly compensated employees.

In many cases, contributors make their gifts upon contingency that the gifts be accorded complete anonymity. Donors should have this right.

These requirements are an improper invasion into the affairs of non-government organizations. The provisions are not germaine to the enforcement of the internal revenue laws. We urge that they be removed at least from the filing requirements of "publicly supported" tax-exempt organizations.

VIII. We are apprehensive that enactment of these complicated strictures on future tax treatment of contributions coupled with actual cancellation of long established tax incentives for giving would prove to be the final push toward a disastrous break-down in the willingness of voluntary givers even to attempt to continue to shoulder these charitable burdens.

A. Government officials had much to say last spring about an impending taxpayer's revolt. In the nonprofit world, we are hearing warnings of a giver's revolt.

B. Preservation of this nation's heritage of generous private philanthropy through the Government's encouragement by granting tax incentives for making charitable contributions is vital to our way of life and to the continued operation of the nation's symphony orchestras.

Mr. Chairman and Members of the Senate Committee on Finance:

My name is Richard H. Wangerin. I appear before this Committee on behalf of the nation's more than 1,400 symphony orchestras and in the capacity of President of the American Symphony Orchestra League.

The League, chartered by the Congress, serves as the nonprofit, tax-exempt educational, service and research membership organization of the nation's symphony orchestras, and derives its basic support from dues paid by those organizations. The League's voting membership consists of nearly every one of the nation's leading symphony orchestras and hundreds of the lesser known symphony orchestras established in the smaller cities.

The League maintains permanent national offices with professional staff in Fairfax County, Virginia.

In presenting the case of the nation's symphony orchestras we are, in effect, presenting also the case of other performing arts organizations - the ballet companies, the opera companies, the chamber music ensembles, the choral groups. The basic economics of all these groups are similar. They share common concern over the effects of certain provisions in the proposed legislation.

We know that the members of this Committee and of the Ways and Means Committee, members of our Congress and of the Executive and Administrative branches of Government have no intention of deliberately causing hardships for the nation's cultural organizations, of curtailing the arts, or of reducing their financial support.

But what apparently is little understood is that many of the provisions under consideration for improving certain aspects of our tax structure will have disastrous side effects for symphony orchestras and all other organizations that depend on charitable contributions for a large part of their support.

Cultural and arts organizations especially will be hard hit; they come at the tail end of philanthropic giving. People generally make contributions to symphony orchestras only after they have given to their churches, their colleges, their hospitals, their community chests. Since this is so, we feel certain that symphony orchestras and other arts groups will bear even more than their aliquot share of the reduced giving that inevitably will result from passage of H. R. 13270.

If the provisions of the House Bill that adversely affect charitable giving are adopted *in toto* and without substantial modification, we are convinced the ultimate result would be the demise of most of our symphony orchestras as we know them today. They inevitably would have to turn to government for direct subsidy. We have little hope that at this time government would give the massive support required to finance the orchestras and other arts groups in view of the already pressing and ever-growing demands upon government funds to meet basic human needs.

We believe that our symphony orchestras are a vital part of our national life, and we beseech you most earnestly to continue the Federal Government's present methods of stimulating private support of symphony orchestras and other cultural organizations through the incentives that the tax laws presently provide.

I. SYMPHONY ORCHESTRAS ARE VITAL TO THE TOTAL CULTURAL AND EDUCATIONAL LIFE OF THE AMERICAN PEOPLE AND THUS MERIT THE CONCERN OF THIS COMMITTEE

Symphony orchestras are part and parcel of our modern nation that operates on the philosophy that the total citizenry should have equal opportunity to partake

of the nation's total cultural activity. Gone are the days when great music, great art, great beauty were reserved for the enjoyment of only the affluent.

Today, there are over 1,400 symphony orchestras in operation in the towns and cities of this nation; 382 of them exist in the home states of just the 17 members of this Committee.

The nation's orchestras exist in large and small cities. They present concerts in hundreds of other towns and cities many of which are too small to maintain their own orchestras.

Altogether, the nation's symphony orchestras play approximately 11,000 symphony concerts a year (an average of over 30 concerts a day) to an estimated gross audience of at least 20 million men, women and children, plus a radio and TV audience of uncounted millions. The orchestras play approximately 3,500 concerts for school children each year and hundreds of free concerts in the nation's parks and civic auditoriums.

Over a third of a million persons are directly involved in the work of these orchestras - including over 80,000 musicians who perform in them, and over 250,000 men and women who serve on the orchestras' volunteer governing boards and committees. Invariably, the top business, industrial, cultural, educational and religious leadership of each community is to be found on these boards and committees. Frequently, the top political, governmental and labor leadership also is represented.

The presence in a community of highly trained symphony musicians enables other sponsoring groups to organize local opera companies and chamber music groups. The presence of these musicians strengthens the teaching resources of the community and enriches the music of the churches.

The nation's 1,400 symphony orchestras provide the only significant employment for musicians in this country who study and train for a career in per-

formance of so-called "serious" instrumental music. It is the orchestras that provide the motivation for millions of young people to engage in the study of music today.

Just as our libraries make available the world's literature to the total population, just as our museums make great art available to the people, the nation's symphony orchestras bring to life the world's great music for the enjoyment and cultural development of the citizens of their home cities.

This, then, is the role of the nation's symphony orchestras in the spiritual, cultural and educational lives of our people - a role that goes back 127 years to the founding of the nation's first symphony orchestra, now known as the New York Philharmonic.

Today, the citizens of every town and city of significant size undertake to establish and maintain their own symphony orchestra just as they support their own local libraries as part of the total cultural and educational facilities of their communities.

II. THE BASIC ECONOMIC STRUCTURE OF U. S. SYMPHONY ORCHESTRAS AND OTHER ARTS ORGANIZATIONS REQUIRES THE SUBSIDY OF CHARITABLE GIVING FOR THEIR VERY EXISTENCE

You well may ask why, if symphony orchestras are so treasured throughout the nation, if so many millions of people want to hear them play, if they serve educational needs of so many children - then why should their financial support have to be of such pressing concern to this Finance Committee?

The reason is very simple and is to be found in the basic economic structure

of symphony orchestras. Such orchestras are comprised of large numbers of highly skilled people - from 65 to over 100 musicians are required to play this music. This means that symphony orchestras are very expensive to operate - so expensive that even the box office revenue from capacity audiences meets less than half the costs. The remaining costs must be met through some form of subsidy.

When we appeared before Congressional committees in 1963 relative to tax proposals which at that time would affect symphony orchestras, we reported that the nation's orchestras were operating on a gross annual expenditure of $30 million, of which they could earn 55%, or $16 million, and that they were dependent on contributed income for the other 45%, or $14 million, of their annual operating costs.

In the intervening six years, population increases and greater demands for concerts for students have served to greatly expand the musical and educational public services required of orchestras. Musicians' salaries have spiralled upwards as have other basic operating costs.

Today, the United States symphony orchestras are operating on a gross annual expenditure of $85 million. They are earning approximately $41 million as compared to $16 million six years ago. Nevertheless, the current earnings represent only 48% of total costs as compared to an earning power of 55% of costs six years ago.

As a result of these changes, the nation's symphony orchestras must now develop $44 million a year in contributed income as compared to $14 million in 1963.

The worsening financial condition of the symphony orchestras is clearly indicated by these figures. The future looks even more bleak.

To understand the basic economics of the performing arts, it must be remembered that:

1. Performances can be produced only through what might be termed "handwork" of each performer.

2. Each concert of a symphony orchestra, each performance of a ballet or opera company is an "original".

It still requires the same number of musicians to play the Beethoven Symphony No. 8 as it did when Beethoven wrote it in 1812. It still requires the same length of time for the 80 to 100 musicians to learn, rehearse and perform that Beethoven Symphony.

There is no way in which orchestras can take advantage of mass production techniques and technological developments that have aided business in meeting rising operating costs through savings in net unit production costs.

In other words, orchestras face the same spiralling costs faced by all other enterprises, but orchestras cannot offset these costs through modern production methods. Due to continued inflation the need for subsidy with which to close this gap between earned income and total costs increases each year. So far, the private sector, encouraged by the Federal Government's tax incentives for giving, has barely been able to keep up with symphony orchestras' needs for increased subsidy - thus, any lessening of these incentives would be disastrous.

In this country, financial subsidies for orchestras have come traditionally from voluntary contributions. In other countries, the subsidy comes directly to the orchestras from their governments.

Under a Ford Foundation grant, our organization has just completed a study of finances and operations of a number of orchestras abroad. The study was made by Howard Taubman, the distinguished critic and writer of the New York Times. The following is indicative of his findings:

a. The Berlin Philharmonic, operating on an annual budget of $2 million, receives $1.5 million from its federal and city governments.

b. The Amsterdam Concertgebouw, operating on $1.3 million annually, receives $900,000 from its governments.

c. The Vienna Philharmonic, which serves also as the orchestra for the Vienna State Opera, receives all of its support from its government - an amount totalling $6 million annually for both the opera and the orchestra.

Mr. Taubman goes on to report that "there is little or no private support of orchestras abroad, by individuals or foundations or corporations. It may well be that a major reason is that there are no provisions for tax deductions for contributors in most countries."

We want to point out that, today, it generally is conceded that the world's leading symphony orchestras are no longer to be found in Europe in spite of the extensive subsidy given by their governments. Today, the world's leading symphony orchestras are to be found in the United States.

The excellence of several of our American symphony orchestras is unsurpassed by those of any other nation, and there is no counterpart in any part of the world for the many competent symphony orchestras found in literally scores of America's lesser known cities.

The results of our Government's traditional policy of tax incentives for charitable giving speak for themselves and commend not only the generosity of our people but the generosity of our Government.

Should this private support be reduced, the orchestras would have no choice but to seek aid directly from government sources, or to abandon their operations - and their music.

III. WHY ARE WE CONCERNED OVER H. R. 13270 ?

We are by no means opposed to this proposed legislation in its totality. As citizens, as representatives of responsible and distinguished civic organizations, we applaud the work of our elected representatives in trying to achieve equity and simplification of our tax laws, in trying to clarify provisions that lead to tax abuses, in strengthening certain filing requirements for private foundations and tax-exempt organizations so as to protect those that are conscientiously trying to do what is right and root out those that deliberately are trying to take advantage of enlightened legislation.

BUT -

The Treasury Department reports that "taking all of the proposed tax changes into account we estimate that there will be a revenue increase to the Treasury in the charitable contribution area in the neighborhood of $100 million".

That is one reason we are concerned.

If this $100 million is channeled into tax revenues instead of to philanthropic causes, then obviously something constructive must be done to offset this financial loss to philanthropic endeavors in this country.

We already have shown why it is necessary for symphony orchestras to depend on some sort of subsidy for half or more of their total financial support. The provisions of H. R. 13270 cut into the ability of every form of voluntary giving to continue to provide financial support of orchestras even at current levels.

A. Take the Matter of Contributions from Individuals:

Currently, symphony orchestras are receiving over half of their subsidy from

contributions made by individuals.

Among the 382 orchestras operating at a total annual expenditure of $17 million in the home states of the members of this Committee, this form of support totals $4.5 million annually.

The proposals of H. R. 13270 would reduce affluent donors' financial ability to give away money as a result of repeal of the unlimited deduction, changed tax treatment of gifts of appreciated property, and gifts of use of property, and proposed changes in many aspects of the more sophisticated types of giving.

Under the Bill, gifts of appreciated property would be discriminated against in several important respects. The tax preference items included in the so-called "Limit on Tax Preferences" (LTP) and "Allocation of Deductions" (AOD) provisions include the appreciation in value of property contributed to charity. Inevitably, this would substantially decrease important "leadership gifts" which are usually in the form of appreciated securities or real estate. For this reason, we heartily support the Administration's recommendation to delete the appreciation element of charitable gifts from those provisions.

However, this still would leave charitable contributions as an item of deduction subject to allocation under the allocation of deductions provision. This would have the effect, we fear, of postponing many substantial gifts until the end of a year when the effects of the complex allocation provision could be finally determined, with the unfortunate result that many such gifts simply would not be made.

Moreover, gifts of appreciated property to public charities would remain subject to the present 30% limitation rather than counting toward the extra 20% to be allowed under the Bill for gifts of cash to "publicly supported" organizations.

We see no reason for such discrimination against gifts of appreciated property.

Furthermore, gifts of appreciated tangible personal property and future interest gifts would be further discriminated against in that the donor would have to limit his deductions to his cost basis or include the appreciation element in his income.

This change may or may not be justified if the property is normally held by the donor for sale to his customers in the ordinary course of his trade or business and thus would produce ordinary income when sold.

However, it certainly is not justified with respect to capital items which, if sold, would produce capital gains. To treat a gift of such items as a constructive sale overlooks the fact that the donor is not confined to a choice of selling or giving away the property but can hold on to it until his death and pass it on to his heirs without income tax consequences. It is obvious that the proposed treatment would discourage future gifts of such property to charity.

In the past for instance, symphony orchestras have been recipients of gifts of rare musical instruments such as a gift of a Stradivarius violin for use by the concertmaster. There is no reason to discriminate against such gifts *vis-a-vis* gifts of appreciated securities or real estate.

For these reasons we approve Treasury's position that gifts of tangible personal property should continue to be allowed the same preferential treatment as gifts of securities and real property would be afforded under the Bill.

Similar treatment should be extended to gifts of future interest.

B. Take the Matter of the Increased Standard Deduction:

There is no question that the process of itemizing contributions on indivi-

dual tax returns and claiming deductions from personal income tax for those contributions provides a tax incentive for giving.

Eighty-eight per cent of the total number of gifts made to symphony orchestras' annual maintenance funds are in amounts of less than $100, averaging $37. These small gifts account for approximately 40% of the total annual contributed dollars received by symphony orchestras.

These percentages apply to symphony orchestras of all sizes - from the New York Philharmonic, Boston Symphony, and the Philadelphia Orchestra on down to obscure symphony orchestras in small towns.

Now comes the proposal to raise the standard deduction. The Ways and Means Committee report estimates that 34 million more taxpayers will use the standard deduction if these changes are enacted. Treasury estimates that at least 8 million more tax payers would use the standard deduction if their version of the proposed change were adopted.

Be it 8 million or 34 million or someplace in between, the statistics include many modest contributors to symphony orchestras and millions of what we hope are prospective contributors.

Under the increased standard deduction the taxpayer, in effect, will receive deduction for charitable contributions whether or not actually made. So, the orchestras face further shrinkage of contributed support as a result of <u>this</u> provision. Again, no spokesman for Government has offered any suggestion whatsoever as to how these losses to philanthropic causes would be offset.

We strongly urge that charitable deductions be isolated from other personal deductions for separate treatment, and that they be subject to continued itemization with deduction permitted even though the proposed increased standard deduction is used, thereby preserving this crucial incentive for continued support

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of philanthropic endeavors. If this plan were adopted we would support adoption of a requirement that receipts or cancelled checks be attached to the tax returns to support claims for all contributions over a stated minimal amount.

We are not against the worthy aim of simplifying tax returns through increased use of the standard deduction, but simplification should not be achieved at the price of reducing support of charitable activities.

C. Take Foundation Aid to Orchestras:

Orchestras are receiving approximately 20% of their contributed support from foundations. Again, we cite the circumstances of the 382 orchestras operating in the home states of the members of this Committee. Foundation aid to these orchestras totalled $1.6 million last year, representing over 18% of their total contributed support.

H. R. 13270 proposes to tax the foundations' investment income by 7 1/2%, and impose various other changes that would serve to reduce future support of existing foundations and deter establishment of new foundations.

If the legislation were enacted, we can only conclude that the amount of money foundations currently are giving to symphony orchestras would be reduced immediately by a factor of 7 1/2% and possibly by a great deal more as the full effects of proposed changes are felt. In other words, it would be the recipients of foundation gifts that would bear the burden of the proposed tax.

We are strenuously opposed to the philosophy of taxing foundation funds for the purpose of adding to the Government's tax revenue, but we endorse Treasury's proposal to substitute for the proposed 7 1/2% tax, a 2% filing fee and to use the income from that fee to pay for increased policing of private foundations by the

Internal Revenue Service. We are heartily in favor of such a program so financed.

Treasury's viewpoint of the total effects of H. R. 13270 provisions concerning foundations does not agree with past experience of recipients of foundation aid.

Mr. Edwin Cohen, Assistant Secretary of Treasury, has this to say about the ultimate effect of those proposals of the Bill designed to require current annual distribution of foundation funds for charitable purposes:

> "We estimate that because of adoption of a rule we recommended to require private foundations to distribute to public charity not less than five percent per annum of the value of their assets, there will be an increase in funds flowing out of private foundations into public charitable and educational organizations on the order of $200 million"* . . .

Mr. Cohen cites the proposed forced distribution of foundations' funds as the offsetting factor for anticipated losses of $100 million to charitable organizations that would result from proposed changes in tax treatment of charitable contributions.

This statement seems to be based on the assumption that the current charitable contribution dollar will be exchanged for two foundation dollars on a *quid pro quo* basis as far as the support of charitable organizations is concerned. Such will not be the case.

Gentlemen, let us explain a little about operations of foundations from the point of view of the recipient organizations.

Foundations are vital to our work. But it must be remembered that foundations become donors. As donors they have the right to choose to whom and for what purposes their money shall be given - within the framework of the law.

As you are so well aware, there are large foundations and small foundations. It is the small local foundations that customarily contribute to annual

* Remarks delivered before the American Bar Association, Section on Taxation, August 9, 1969

operating funds of symphony orchestras and other tax-exempt organizations.

The large foundations seldom contribute to these on-going operating expenses of organizations. Instead, their gifts usually enable an organization to experiment with a challenging new idea, engage in much-needed research, undertake some project with foundation funds during the period that more permanent, on-going support is gradually developed for the future financing of that activity.

Indeed, the charters and/or trustee resolutions of many foundations expressly forbid granting of funds to organizations for the purpose of meeting annual operating deficits because this is a never-ending need. Foundation funds very quickly could become tied up entirely in commitments for organizations' annual operating funds thereby leaving almost no resources with which to aid in experimental work and expansion of programs and services.

Let me give you a few examples of how this distribution of foundation funds customarily works in the orchestra field.

Take the American Symphony Orchestra League itself:

In addition to dues paid by our members, we must obtain about $40,000 annually in contributions to finance our on-going services to the orchestras. Last year, foundation gifts accounted for approximately 25% of our annual maintenance fund.

However, it has been through substantial gifts from the Rockefeller Foundation and other Rockefeller philanthropic interests that the League has been enabled to:

- Initiate and maintain a comprehensive training program for young conductors, composers, and orchestra musicians for the last 13 years.
- Initiate and maintain the first formal, in-service training projects for orchestra managers.
- Make the first comprehensive study of the arts council movement.

- Undertake the first comprehensive research on basic legal documents of symphony orchestras, and publish the only manual in this basic aspect of their work.

- To experiment in psychological testing of orchestra managers.

- To make career grants to a few outstanding young American conductors some of whom now are emerging as leading young conductors of our country.

Under a current Ford Foundation grant, we undertook the first comprehensive study of operations of European orchestras that I referred to earlier, and now are engaged in a complete analysis of the bookkeeping and auditing practices of symphony orchestras so that truly comparable statistics can be made available when the U. S. Department of Labor, the U. S. Department of Commerce, the State Department and Treasury call for such material - as they frequently have done in the past.

The League could not have done any of these important things from its regular income. Neither would we have been granted these funds by the large foundations for the purpose of financing our basic, on-going, day-to-day work. We have made such requests and have been turned down.

The Ford Foundation's recent massive grants to 61 symphony orchestras are another good example of foundation policies in selecting projects they wish to support. These grants, totalling $80 million, were given for the express purpose of aiding orchestras in establishing permanent endowments. The orchestras are required to match the foundation funds on a 1-to-1, 2-to-1, or 3-to-1 basis depending on the circumstances of each orchestra.

Another requirement for eligibility for these grants is that the orchestras must maintain their local annual contributed support at least at former levels. In other words, the endowment grant program added a challenging new dimension to symphony orchestra finance and operations, but it was not a substitute for continued local contributions toward the day-to-day work of the orchestras. Annual

gifts from individual contributors continue to be absolutely vital to the existence of the orchestras - even those that received the endowment fund grants.

These examples are typical of the manner in which foundation funds flow into symphony orchestras - funds from local foundations to help meet annual expenses - larger grants from the large foundations for expansion of program, research and experimentation.

It is completely unrealistic to assume, therefore, that plans to force distribution of foundation assets will result in replacement of losses suffered by tax-exempt organizations as a result of changes in tax treatment of individual charitable contributions.

Yet, unrealistic as it is, this is the only official release of the Government having come to our attention that offers any statement of what might be put in place of the $100 million now going to charitable organizations but slated to go to the U. S. Treasury under H. R. 13270.

Furthermore, even if the initial effect of forced distribution would be to add to the amount of cash made available to charitable organizations, the long range effect would be the shrinkage of capital funds for future support of charitable organizations. Of course, we are not opposed to distribution of private foundations' annual income, but we are opposed to forced distribution of their capital. In this proposal, we can see only the ultimate liquidation of foundations.

In connection with the Bill's provisions on foundations, we want to commend the House on its final action to make it possible for foundations to continue to make grants to individual musicians, conductors, composers, etc. under IRS-approved plans.

:. Total Effect of the Losses from Reduced Tax Incentives for Giving:

When we total the dollar losses in contributed income that would result from these many reduced tax incentives for charitable giving as proposed in H. R. 13270, they spell life or death for symphony orchestras. But the dollar gains the Government would realize from these tax changes would become only a statistic in the financial reports of the United States Treasury - a statistic that will not produce music, a statistic that will not add one iota to the nation's cultural development of the future, a statistic that never can produce America's Beethoven, another Isaac Stern, a statistic that never can be transformed into America's next George Gershwin or next Leonard Bernstein.

If our Congress goes ahead with these proposed changes that will result in withdrawing at least $100 million annually from support of tax-exempt organizations - if this be the plan then, in all seriousness, perhaps we should propose the following:

That there be included in the tax legislation a provision whereby a stated percentage of the nation's Federal tax revenue be set aside for direct payment for support of philanthropic organizations.

We realize it is not within the province of this Committee to initiate appropriations. We are told over and over that the demands upon our Government for financial solution of the problems of the cities, of the Vietnam war, of the space program, of health and welfare needs, of public education, of the care of the aged - that these demands would preclude serious consideration of such a proposal at this time.

If that be the case, we most earnestly beseech you to protect what we already have in the way of support by continuing the tax incentives that encourage

our people to give voluntarily on behalf of the public good.

Without this continuing support through federal tax policies, the symphony orchestras of this nation eventually will have only two alternatives:

1. To come to Congress year after year seeking direct subsidy in ever-increasing amounts of money;

2. To disband.

In addition to our concern over these overwhelming financial problems the proposed legislation poses for us, we are concerned also with some technical problems raised by the Bill.

E. Take the Matter of the Proposed New Definition of "Private" Foundations:

First, we are concerned that the proposed definition of "private foundations" for purposes of the new tax provisions may inadvertently cover many organizations that should not be treated as "private foundations".

Many deserving organizations may fail to meet the second exception provided for determining what organizations are not "private foundations", because of unwarranted restrictions: (1) that gifts from "substantial" contributors (i.e., those who contribute more than $5,000 in any one year) cannot count toward the required 1/3 public support test; (2) that related income receipts from any "person" in excess of 1% of total support likewise do not count towards 1/3 "public support"; and (3) that 1/3 of total support cannot come from gross investment income.

We point out that under the 1% rule, it is only the amount in excess of 1% that is excluded from qualifying as "public support", whereas the entire amount of the over-$5,000 gift is excluded. We feel that at least the first $5,000 of a large gift should count as a part of an organization's public support.

Secondly, the phrase "any person" is too broad in that it would subject to the 1% rule payments made by government units and public charities. It is ridiculous to exclude any part of support from public funds from "public support".

The third test should be dropped. Since investment income already is included in total support and more than 1/3 of total support must be derived from gifts, contributions, membership fees, admissions or other related income in order to qualify the organization as "publicly" supported, there is no reason for having a separate limitation as to the amount of investment income. It serves only to penalize those organizations which have received substantial contributions from generous donors in the past to build up endowment funds.

Moreover, the third exception has a number of technical defects:

(1) It certainly could not have been intended to penalize a trust which now must be operated entirely for charitable purposes simply because, as originally constituted, part of the income was required to be distributed to private annuitants for a term of years or for their lives.

(2) It also should be made clear that organizations with defective charters may amend them to satisfy the "organized" test.

(3) There is no reason why a separate organization which is operated "in connection with" two or more qualified institutions rather than one such institution should not be protected under the third exception to the definition of a "private" foundation.

Unless substantially modified, these provisions relating to determination of what organizations are not "private" foundations are going to result in unending work for the IRS and will place an especially unwarranted burden upon predominately volunteer, small budget charitable organizations that cannot afford to employ professional staff and legal counsel.

Just within the symphony orchestra world alone, the Service will be besieged with inquiries, requests for explanations, and 30% classification applications from literally hundreds of small budget orchestras and modestly financed women's auxiliaries of symphony orchestras.

F. Take the Matter of the New Requirements on Disclosure of Information

We strongly support the provision requiring all tax-exempt organizations to file an annual return.

However, we challenge the proposed additional requirement that all 501 (c) (3) organizations be required to file listings of major contributors and amounts given, and names and salaries of highly compensated employees.

In many cases, contributors make their gifts upon the contingency that the gifts be accorded complete anonymity. Donors should have this right. And what useful purpose possibly can be served by the United States government having a list of salaries and fees paid to symphony orchestra conductors, concertmasters and first oboists?

These requirements are an improper invasion into the affairs of non-government organizations, and the provisions are not germaine to the enforcement of the internal revenue laws. We urge that they be removed at least from the filing requirements of "publicly supported" tax-exempt organizations.

IV. IN CONCLUSION -

It must be remembered that voluntary giving is a fragile thing. It has to be encouraged, nurtured, protected.

Voluntary gifts cannot be legislated into being; they cannot be produced on demand. There is a limit to the giver's willingness to give.

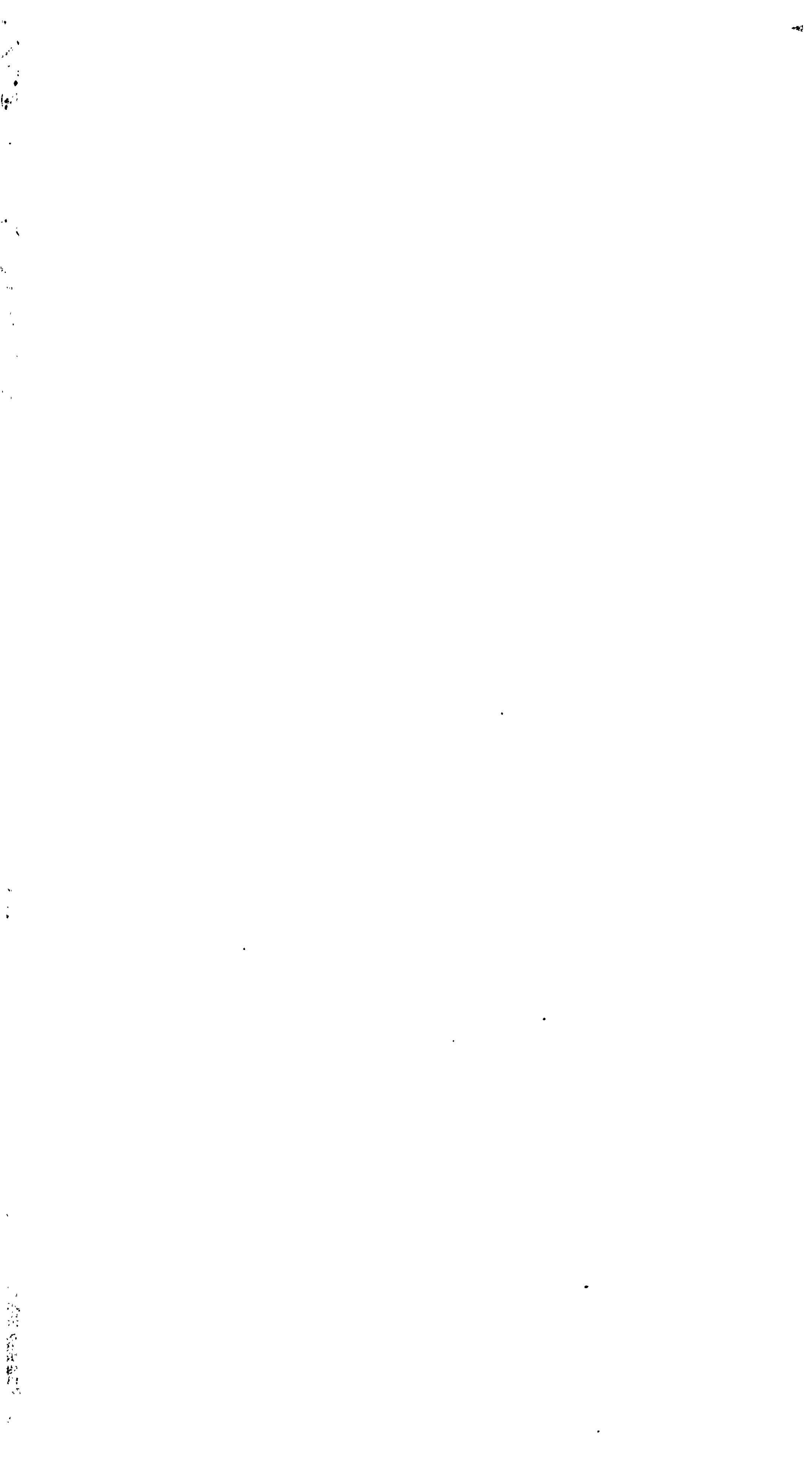
Government officials had much to say last spring about an impending taxpayer's revolt. In the nonprofit world, we hear warnings of a giver's revolt, and rumblings of the exhaustion of the volunteer civic leadership required to keep these contribution campaigns going year after year.

As operating costs spiral and force charitable and educational organizations each year to seek more and larger contributions than the year before, we fear the day will come when the givers will lapse into a state of utter frustration and hopelessness over their ability to meet the challenges of private philanthropy.

We may be close enough to this point that enactment of these complicated strictures on tax treatment of contributions coupled with actual cancellation of long established tax incentives for giving would prove to be the final push toward a disastrous breakdown in the willingness of voluntary givers even to attempt to continue to shoulder these charitable burdens.

America's record in private philanthropy is one of the things that sets it apart among all nations. That record is due to courageous and enlightened tax policies of our Government throughout its 193-year history.

We plead with our Government to continue searching for a solution that will correct tax abuses but that will not induce paralysis of this nation's private philanthropy.



SUMMARY

I. THE PROVISIONS OF H.R. 13270 WILL ADD TO THE COST OF LOCAL GOVERNMENTS. THE PREPONDERANT SHARE OF THE MUNICIPAL CAPITAL NEEDS OF PEOPLE ARE PROVIDED BY THE USE OF MUNICIPAL BONDS. IN THE FIVE-STATE AREA OF IOWA, MINNESOTA, NORTH DAKOTA, SOUTH DAKOTA AND WISCONSIN THE ADDITIONAL COST OF THE 1969 FINANCING THROUGH AUGUST COULD HAVE BEEN AT LEAST $271,000,000 MORE WITHOUT TAX EXEMPTION.

II. EXEMPTION OF MUNICIPAL BOND INTEREST FROM FEDERAL TAXATION IS ONE OF THE OLDEST SUBSIDIES IN THE HISTORY OF OUR COUNTRY. IT IS UNIQUE IN BEGINNING AT THE SOURCE. IT PRODUCES 100 CENT DOLLARS. IT IS ECONOMICAL. IT IS EFFICIENT.

III. THE PROVISIONS OF THE TAX REFORM ACT WILL IMPAIR THE MARKETING OF MUNICIPAL BONDS TO THE DETRIMENT OF THE POOR COMMUNITIES.

IV. MUNICIPAL BONDS ARE "PEOPLE BONDS". THEY MAKE POSSIBLE THE FACILITIES WHICH LOCAL GOVERNMENTS NEED TO FURNISH FOR THE SATISFACTION OF THE NEEDS OF THEIR PEOPLE.

V. THE MUNICIPAL BOND PURCHASER DOES PAY A TAX — ONE THAT INURES TO THE BENEFIT OF EVERYONE IN THE COMMUNITY IN WHICH HE INVESTS.

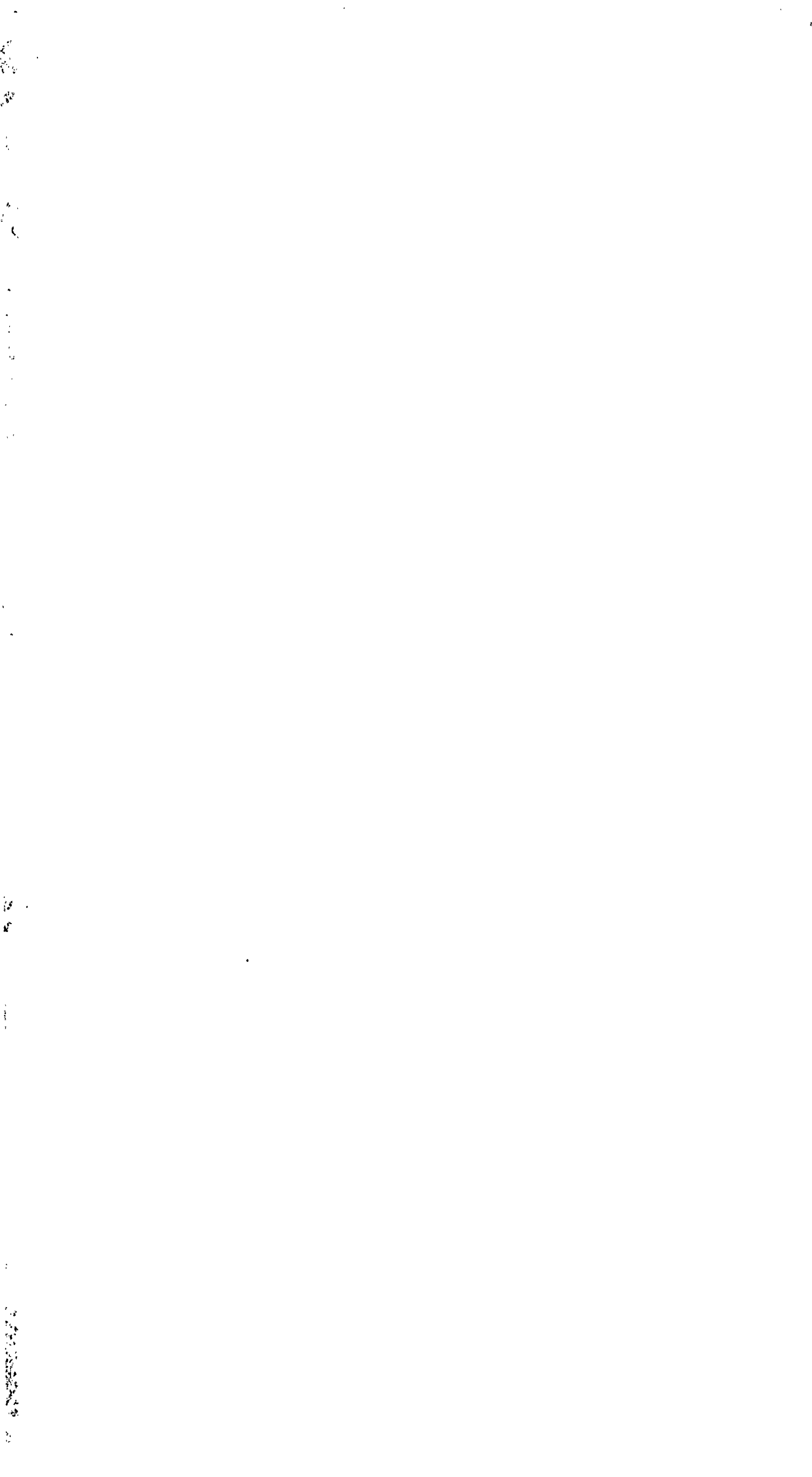
VI. THIS IS AN INOPPORTUNE TIME TO CONSIDER INNOVATIONS TO THE SYSTEM OF MUNICIPAL FINANCING.

VII. THE PROPOSED LEGISLATION COULD MEAN AT LEAST A TEMPORARY SUSPENSION OF MUNICIPAL FINANCING BY THE ISSUANCE OF BONDS.

VIII. THE PROPOSED LEGISLATION CAN BE EXPECTED TO ADD ADMINISTRATIVE OVER-BURDEN.

IX. IMPAIRMENT OF THE TAX EXEMPT STATUS OF MUNICIPAL BONDS WILL CONTRIBUTE FURTHER TO THE TAX PROBLEMS OF LOCAL GOVERNMENT.

X. THE PROVISIONS OF H.R. 13270 MUST BE ACCEPTED AS A HARBINGER OF FURTHER EROSION OF THE EXEMPTION OF MUNICIPAL BONDS.



HONORABLE SENATOR RUSSELL LONG, CHAIRMAN,
AND MEMBERS OF FINANCE COMMITTEE
UNITED STATES SENATE

TESTIMONY OF OSMON R. SPRINGSTED
THURSDAY, SEPTEMBER 25, 1969, 10:00 A.M.

WITH REFERENCE TO THE PROVISIONS OF
H.R. 13270, TAX REFORM ACT OF 1969,
RELATING TO THE IMMUNITY OF THE YIELD OF
MUNICIPAL BONDS FROM FEDERAL TAXATION

Springsted Incorporated is a municipal consulting firm engaged principally with municipal financing. As such, it is currently serving 118 units of government in the five-State area of Iowa, Minnesota, North Dakota, South Dakota and Wisconsin. The firm will assist its clients with approximately 90 million dollars of bonding this year. It does not buy or sell bonds. Its only concern is to assist the municipalities it serves to accomplish the issuance of their bonds as economically and expeditiously as possible.

Through August of this year there were at least 367 bond offerings totalling in excess of $452,000,000 by the local governments of this five-State area. The average size of the offerings was $1,234,092 but they ranged in size from $14,000 to multi-million dollar sales.

The proceeds of these bond issues were used to build schools, streets, sewers, parks and all of the other facilities required to meet the people needs of local government.

Assuming an average rate of 6%, on average maturity of only 15 years and that a tax-exempt rate of 6% is as much as 60% of a taxable rate, these communities were able to give their people a better drink of water, a better school at a cost $271,000,000 less than if they had not been able to issue tax exempt bonds.

They saved their taxpayers this sum by being able to avail themselves of one of the oldest, if not the oldest, Federal subsidy programs of our Country —— the tax exemption of municipal bonds. It is a unique program. It starts and ends entirely with the beneficiary. There are no administrative costs. The recipient gets 100 cents for each of its dollars. There are no regulations. There are not protests of forfeiture of local autonomy. There are no legions of administrative staffs. There are no letters to Senators or Congressmen. It's difficult to think of any self-help program that has worked much better. It is the program by which the preponderant part of our local municipal capital improvements have been, and are being, built at the current rate of about $15 billion dollars a year.

Perhaps the program is ahead of its time. Some of our Federal Agencies today are just realizing the benefits of encouraging the local unit to undertake all of the financing of a Federal-sharing program. Then the agency subsidizes the interest difference. So instead of its borrowing its full share at 8% to lend back to the local unit at 3%, the agency borrows only a fraction of the amount to subsidize only the rate difference.

Without tax-exemption many of the communities of our area, in our opinion, could not provide for their own needs. Remove the tax exempt

status from the offering of a "Ba" rated community with a per capita debt of $1,100 for local indebtedness and place it in direct competition for the investment dollar with an offering of General Motor's bonds and the ratio of a tax exempt rate to a taxable one will realistically be at least 1 to 2. In other words, if such a community must now pay 7% for tax exempt money, it can expect to pay 14% for taxable bonds. Thus, the maximum 40% subsidy of H.R. 13270 will leave it paying a net rate of 8.40% or 1.40% more than it now is. And, of course, if the subsidy is ultimately lowered to 25%, as it may be, the Community is then left in the position of paying 10.5%. This assumes that it can find a buyer!

The municipality may still, under the provisions of the proposed legislation, elect to continue to sell tax-exempt bonds. But it will be in a contracted market if this legislation is enacted. For the good municipal credits it may be to their advantage to elect to issue taxables. This will then leave the municipal market only to the poor. Like any other business, there has to be merchandise for the underwriters of municipals. Reduce the supply and the quality and a natural concomitant must be a withering distribution organization. In our opinion the underwriters of this Country have done an outstanding task of merchandising the bonds of our local governments. They can not be expected to continue their high performance if they are left only the drippings.

Really municipal bonds should be called "People Bonds" because the things they make possible are evidenced from the time each of us turns on a faucet in the morning until we fall asleep to the klaxon of a fire

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TRUCK. THE BATTLE CRY OF THOSE WHO WOULD IMPAIR THESE PEOPLE BONDS IS THAT THE PERSON WHO HAS INVESTED IN PEOPLE IN PREFERENCE TO SOME PURELY PROFIT-ORIENTATED VENTURE HAS COMMITTED A VENOMOUS CRIME UPON SOCIETY BECAUSE HE PAYS NO INCOME TAX. BUT HE HAS. IF HE PURCHASED A STATE OF MASSACHUSETTS BOND IN 1960, WITH A COUPON OF 3.10%, NOT ONLY DID HE ACCEPT A LOWER RATE OF INTEREST THAN IF HE HAD PURCHASED A TAXABLE BOND, BUT HE FORFEITED ANY GROWTH BENEFITS. IN FACT, HE HAS EXPERIENCED THE OPPOSITE RESULT. HE IS STILL GETTING ONLY 3.10% WHEN THE RATE NOW QUOTED FOR THE BOND IS 7.00%, AND HIS BOND IS WORTH LESS THAN 71 CENTS ON THE DOLLAR. HE DOESN'T NEED MUCH ENCOURAGEMENT TO BECOME DISCOURAGED WITH MUNICIPAL BONDS.

WHILE WE ARE UNWILLING TO CONCEDE THAT THERE IS EVER A TIME TO TAMPER WITH THE EXEMPTION OF MUNICIPAL BONDS, CERTAINLY NOW IS NOT IT. ALREADY SUFFERING WITH THE REST OF THE ECONOMY FROM THE HIGH COSTS OF MONEY, OUR LOCAL GOVERNMENTS ARE FURTHER INOPPORTUNED BY THE EVEN HIGHER COSTS IMPOSED BY THIS THREAT TO THEIR MAJOR MEANS OF MEETING THEIR CAPITAL NEEDS. MANY HAVE NOT BEEN ABLE TO SELL THEIR BONDS WITHIN STATUTORY RATE LIMITS. THIS HAS MEANT FURTHER DELAY AND COST IN THE EFFORTS OF THESE LOCAL GOVERNMENTS TO ATTEMPT TO SATISFY THE NEEDS OF THEIR PEOPLE. AND, PROBABLY HAS SERVED TO INTENSIFY THE ALREADY CLARION CALLS FOR HELP TO THE FEDERAL GOVERNMENT.

AS A VERY PRACTICAL POINT, UNTIL STATE LEGISLATURES COULD MEET TO REMOVE EXISTING RATE LIMITS, FEW MUNICIPALITIES COULD ISSUE TAXABLE BONDS TODAY. IF THEN THE EFFECT UPON THE MUNICIPAL MARKET IS WHAT WE THINK IT WILL BE IF THE TAX EXEMPT STATUS OF MUNICIPALS IS IN ANY WAY IMPAIRED, WE FORESEE

A HIATUS IN MUNICIPAL BUILDING PROGRAMS THROUGHOUT THE NATION. PERHAPS THERE IS SOME ECONOMIC MERIT IN THIS, BUT IT TOTALLY IGNORES THE FACT THAT THE KIDS ARE WAITING TO ENTER THE SCHOOL EVEN BEFORE THE FOOTINGS ARE BEGUN. THE OOZE OF THE POLLUTED RIVER KNOWS NO MORATORIUM.

WE RECOGNIZE THAT ASSURANCES ARE BEING MADE THAT THERE WILL BE LITTLE OR NO ADMINISTRATIVE OVERLAY FOR THOSE BOND ISSUES WHICH WOULD BE SUBSIDIZED IF AN ISSUER ELECTS TO FLOAT TAXABLE BONDS. REFRESHING AS IT MAY BE TO BELIEVE THIS MIGHT BE THE CASE —— IT WILL ASSUREDLY BE DIFFERENT FROM ANY OTHER FEDERAL PROGRAM. AT THE MOMENT A WISCONSIN CLIENT HAS BEEN WAITING 60 DAYS, AND IS NOW ADVISED IT MAY BE ANOTHER 60 DAYS, FOR THE PREPARATION OF THE REGULATIONS WHICH WILL PERMIT IT TO ISSUE FEDERALLY SUBSIDIZED BONDS. IN THE MEANTIME, BOTH INTEREST RATES AND CONSTRUCTION COSTS HAVE RISEN AND THE MUCH-NEEDED PROGRAM DELAYED. IT IS TO US, FRANKLY, DOUBTFUL THAT ALL THAT THE VILLAGE CLERK OF EVENING SHADE WILL NEED TO DO IS TO DROP A HANDWRITTEN NOTE ON A SHEET OF TABLET PAPER TO THE SECRETARY OF THE TREASURY ADVISING HIM THAT EVENING SHADE A FEW MONTHS AGO ISSUED SOME TAXABLE BONDS AND SEEING AS HOW THERE IS AN INTEREST PAYMENT DUE NEXT WEEK WILL THE SECRETARY PLEASE SEND A CHECK FOR THE FEDERAL GOVERNMENT'S SHARE. IT SEEMS REASONABLY CERTAIN THIS IS A CONDITION TO WHICH THE REFLEXES OF GOVERNMENT LAWYERS COULD NEVER ADJUST.

LOCAL GOVERNMENTS HAVE LITTLE PROSPECT OF GAIN IN THESE PROPOSALS BUT ALMOST CERTAIN ASSURANCES OF LOSING. AT BEST, THEY CAN ONLY HOPE TO BORROW THEIR MONEY AT ABOUT THE SAME RATE THEY NOW ARE. IT IS FAR MORE PROBABLE THEY WILL PAY MORE. ALREADY IN THE POSITION OF HAVING THE FEDERAL AND STATE GOVERNMENTS HAVING TAKEN THE BIG BOY'S SHARE OF THE REAL GROWTH FACTOR IN OUR

economy — income — this means they must again add yet another layer upon the only major tax left them —— the property tax which comes from a source far less responsive to growth than income. Less related to ability to pay, too, we might add.

We do concede that the provisions of H.R. 13270 which relate to the taxation of income of municipal bonds directly, or indirectly, of themselves should not conceive all of the dangers we foresee. But they are truly warnings to the municipal investor. If now the historic inviolability of the income of municipal bonds from Federal taxation is in any manner impaired the investor must be most apprehensive of what may follow, especially when it was announced by a spokesman for the House Ways and Means Committee when the bill was introduced in the House that it was the avowed purpose of the Committee to eliminate the tax exempt status of municipal obligations. The buyer of a bond of the Burnsville, Minnesota School District maturing in 1990 must live by his contract. He can not come back for an upward adjustment of the rate or demand prepayment no matter how equitable his request may be. He invested in the people of that School District accepting his contract and believing his rights would be protected.

We urgently request that the proposals of H.R. 13270 which will infringe in any manner upon the exemption of municipal bonds from Federal taxation be conclusively rejected. To do otherwise, in our opinion, will be to add even further costs to already tax bent local communities, will impose even greater burdens upon local boards and administrations in their never ending search for revenues and will further delay any hope of meeting the local needs of the people of this Country.

We've got a pretty good system, let's not mess it up!

SENATE FINANCE COMMITTEE

HEARINGS ON H. R. 13270

September 25, 1969

Formal Statement of the Honorable Edgar F. Shannon, Jr.

President, University of Virginia

Arbitrage Bonds

Summary

The University of Virginia desires to issue bonds secured by and payable out of mortgages taken as security for loahs made by the University for faculty housing.

In the opinion of bond counsel, the interest on these bonds would be exempt from Federal taxation under present laws. The arbitrage bond provisions of the Tax Reform Act, as reported by the House Ways and Means Committee and as passed by the House, appear to prevent these bonds from being issued by the University as tax exempt bonds.

The University urges the Senate Finance Committee to amend the language of proposed Section 601 of H.R. 13270 to make clear that the definition of arbitrage bonds will not apply to the University's bonds secured by mortgages on faculty housing.

Discussion

The University of Virginia proposes to issue bonds pursuant to Virginia Code Section 23-30.01 passed by the General Assembly of Virginia. That section authorizes any State educational institution, with the approval of the Governor, to issue bonds secured by and payable out of securities held by its endowment fund where the securities are secured by a lien upon real estate or personal property.

The University now holds in its endowments approximately $8,000,000 in notes and mortgages received as security for loans on faculty housing. These mortgage loans all derive from the University's overall plan to assist faculty and student housing, and have been made to faculty members to aid in the financing of their homes at a rate of interest approximately one percentage point less than the available market for mortgage loans.

Of necessity, the University cannot issue its bonds every time it proposes to make an individual mortgage loan. It must rely on its endowment funds to make the necessary advances, accumulate the mortgages, and then fund the obligations by issuing its bonds when sufficient mortgages have been accumulated.

It is the opinion of bond counsel that, under the present tax law, interest on the bonds to be issued as discussed above would be construed by a court to be exempt from Federal income taxes as interest on bonds issued by or on behalf of an instrumentality of the State of Virginia.

The House Proposal

H.R. 13270, the Tax Reform Act, as passed by the House of Representatives contains a provision on "arbitrage bonds" which, if adopted, would in all probability prohibit the University of Virginia from issuing tax exempt bonds secured by mortgages held in its endowment funds, as permitted by Section 23-30.01 of the Virginia Code. Section 601 of the Tax Reform Bill contains the following amendment to Section 103 of the Internal Revenue Code (Section 103 grants the exemption for interest on bonds of states and political subdivisions):

> "(b) Arbitrage Obligations - Section 103 is amended by inserting after Subsection (c) the following new subsection:
>
> > '(d) Arbitrage Obligations - Under regulations prescribed by the Secretary or his delegate, any arbitrage obligation shall be treated as an obligation not described in Subsection (a)(1)'".

In the Act the effective date of this amendment is July 11, 1969.

The report which accompanied the bill makes the following

explanation of the proposed amendment:

> "Some state and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from tax exempt issues are employed to purchase higher yielding Federal obligations whose interest is not taxed in their hands. The tax exempt issue in these cases generally specifies that the interest on the Federal bonds will be used to service the state and local securities. An individual who purchases a state or local security under such an arbitrage arrangement has the advantage of a tax exempt security with the safety of a Federal security. The Federal government then finds itself in the position of becoming an unintended source of revenue for state and local governments while losing the opportunity to tax the interest income from its own taxable bond issues. The Internal Revenue Service has announced that it will not rule on the question whether such arbitrage obligations are entitled to tax exemption under existing law." H. Rep. 91-413, part 1, page 173.

The Committee report correctly states the Treasury Department's current problem, but the broad sweep of the language in the Act goes much further. The Treasury Department has been concerned about the issuance of tax exempt securities the proceeds of which are reinvested in Federal securities required to be held as security for the tax exempt security so that the holder has, in effect, a tax exempt Federal security.

The language in the Act as passed by the House of Representatives would permit the Internal Revenue Service to forbid the University from issuing its bonds and reinvesting in new securities

(e.g., United States or corporate bonds, preferred stocks or equity stocks), whether or not these new securities were pledged as security for the bonds. It also appears that the Act could be extended to prohibit the use of securities already held in the University's endowment funds (e.g., existing mortgages) as security for the University's bond issue.

Reliance Upon Administrative Regulations

The administrative interpretation of proposed Section 601 would undoubtedly extend its scope beyond the Treasury's problem in the use of tax exempt securities to finance reinvestment in Federal securities. When applied to the University's use of bond proceeds to fund mortgages held in its endowment funds, technically, the mortgages held as security for the payment of the bonds constitute securities the interest on which is taxable, while the interest on the bonds is tax exempt.

Such an interpretation of the present House provision would ignore the fact that, under current market conditions (and for the foreseeable future), the coupon rate of the University's bonds would be higher than the current 5.08% average interest rate in the faculty loan portfolio. Thus, the amount of bonds which the University could issue (perhaps $7,000,000) would be sufficiently less than the amount which it has already invested in the faculty mortgages (i.e., $8,000,000). This difference, represented by a discount from the principal balance of the mortgage collateral (i.e., money

already advanced from the endowment funds), would continue as a subsidy by the University for its faculty housing and represent no benefit to the State from the tax exempt financing. The University does not engage in the buying and selling of mortgages at a discount but invest in each faculty loan the full principal amount of the mortgage. Therefore, such investment, rather than any hypothetical market value for the mortgage, is the proper measure of the University's needs and the proper standard for judging whether the University's bonds actually operate as an arbitrage.

It might also be argued, by one who overlooks the entire purpose of the transaction, that in view of the fact that the bond issue will free an equivalent amount of endowment funds for investment in other securities, whether bonds, preferred stocks, or equity stocks, the University's bonds would be issued for the benefit of its endowment funds, and the endowment funds will be entitled to invest the proceeds in taxable obligations even in the traditional arbitrage context. Such a view, however, totally disregards the true purpose of the University's bond issue (namely to fund the faculty home loan program) and the impracticability of issuing bonds to cover each individual $20,000, $25,000 and $30,000 faculty home mortgage.

Further, the present language of Section 601 of H.R. 13270 grants such broad latitude to the Secretary of the Treasury that he could deny the tax exemption for interest on any bonds issued by the University, regardless of the security, so long as the University owns securities the interest on which is taxable.

For instance, the Secretary could argue that the University should sell its endowment securities to build dormitories, rather than issuing tax exempt bonds to finance their construction. He has made a similar argument against individuals and corporations who hold tax exempt securities when they borrow money for purposes unrelated to their holding of the tax exempt securities. See, e.g., Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420 (7th Cir. 1968).

Assistant Secretary Edwin Cohen, in his statement to the Senate Finance Committee on September 4, recognized that the language in the Act on arbitrage bonds as passed by the House was too broad. He stated:

> "The bill would also deny tax exempt status to so-called 'arbitrage bonds,' the specific definition of which is left to the regulations. We believe that this is in general a proper method of handling that abuse, but we believe the scope of the term 'arbitrage obligation' should be described with some further particularity in the bill." (Senate Finance Committee, Committee Print, p. 85).

As of Saturday, September 20, 1969, the Secretary has made no specific proposal, and we understand that emphasis will be placed again on an administrative interpretation. Cf. T.I.R. 840 (August 11, 1966), attached as Exhibit A hereto. We strongly recommend, however, that the language as passed by the House be amended in the Act to permit the University to issue tax exempt bonds to aid in the financing of its faculty housing needs.

We cannot afford to leave such exemption to administrative regulation for several reasons:

1. The present volatile state of the tax exempt bond market is known to all of you. Underwriters cannot maintain any kind of orderly market and wait the weeks and sometimes months necessary to obtain a ruling from the Internal Revenue Service.

2. This delay factor is especially evident now when the regulations for the entire new bill are yet to be written. Any interim administrative regulations would not permit bond counsel to avoid requests for ruling. Actually, such requests would become a necessity.

3. Any temporary administrative regulation keyed to a use of proceeds to reinvest in taxable securities (as opposed to taxable Federal securities) to be held as security for the tax exempt bonds would be unworkable because, technically, faculty mortgages are securities the interest of which is taxable. The use of the old rules (i.e., T.I.R. 840) would not ease the situation because the entire context of interpretation would have changed; that is, T.I.R. 840 would now be viewed as an expansion of specific legislation limiting arbitrage situations, whereas under former law arbitrage bonds were permissible under the statute

as an additional indirect subsidy to State and local governments.*

4. If the funding of the mortgages is indeed an arbitrage under the statute, the Treasury would not have the authority to issue regulations which would exempt a specific program such as aid to faculty housing.

Congressional Support of Housing Aid

There is ample precedent in current Congressional policy for a statutory exemption to permit the University to aid the furnishing of its housing needs in this way. First, the Federal government guarantees payment of bonds on all local housing authorities in the country. In effect, therefore, it gives to the bondholders, when housing is involved, a tax exempt Federal security. Second, the Congress last year, when adopting restrictions on tax exempt industrial development bonds, provided an exemption for bonds to finance "residential real property for family units." Third, in the Act as passed by the House the recommended changes in the deduction for depreciation do not apply to new "residential rental housing." (Section 521 of H.R. 13270).

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* In truth, what is so wrong with arbitrage bonds issued by instrumentalities of State and local governments? If the Commonwealth of Virginia issues $36,000,000 of its 6% tax exempt bonds and uses the proceeds to purchase at the current market discount $40,000,000 in 6% taxable Federal bonds, using the $4,000,000 arbitrage spread for the construction of hospitals, housing or other publicly supported capital needs, why is this so sinful? As pointed out below, the Federal government actually encourages this with respect to local housing authority bonds!

The needs of a university in the housing area are as important as the policies underlying the need for these statutory exemptions. At the University of Virginia alone, the endowment funds already hold almost $8,000,000 in mortgages on faculty homes. It is projected that by 1975-1980 there will be a need for $7,000,000 more, or a total of $15,000,000.

Last year legislation was introduced in the Senate and agreed to by the Treasury Department which would have addressed itself specifically to the Treasury's problem with arbitrage bonds. S. 2636, introduced by Senator Ribicoff, defined "arbitrage bonds" in the bill and denied tax exemption for interest on such bonds. The language of S. 2636, to a great degree, incorporated the Internal Revenue Service's prior announcement in T.I.R. 840. The Treasury Department supported S. 2636 at that time. (Hearings before Senate Finance Committee on Tax Adjustment Act of 1968, page 90).

A statutory definition of "arbitrage bonds" such as presented in S. 2636 might not apply to the University of Virginia bonds. In any case, an amendment, which would be only a clarifying amendment, could be added to the other exceptions to the definition of "arbitrage bonds" in that bill to make clear the definition did not apply to faculty housing bonds. This would be only one available alternative.

Conclusion

We, therefore, strongly urge the Senate Finance Committee to define arbitrage bonds with some particularity and with a definition or an exception in the Act which would permit the University to issue its bonds to aid in the financing of its faculty housing programs. We base this request on two basic premises:

1. The privilege now accorded to State supported universities to issue evidences of indebtedness carrying tax exempt interest extends to indebtedness incurred for faculty housing.

2. Even though generality and simplicity are desirable attributes of a tax statute, the tax law adopted should not create uncertainties and confusion when exposed in the light of real situations.

If this Committee accepts these premises, it should accept our request.

Edgar F. Shannon, Jr.
President
University of Virginia

EXHIBIT A

T. I. R. 840

TECHNICAL INFORMATION RELEASE OF THE U.S. TREASURY DEPARTMENT, INTERNAL REVENUE SERVICE, PUBLIC INFORMATION DIVISION, AUGUST 11, 1966

The U.S. Internal Revenue Service today announced details of its policy of *declining* to issue rulings that the interest on certain obligations is exempt from Federal income taxation under Section 103 of the Internal Revenue Code of 1954.

The policy will continue in effect, pending the conclusion of a study to determine whether such obligations should be considered obligations of States, Territories, possessions, their political subdivisions or the District of Columbia. The study will be directed at obligations issued by these governmental units where a principal purpose is to invest the proceeds of the tax-exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield. The profit received by the governmental units on the difference between the interest paid on the exempt obligations and the interest earned on the taxable obligations is in the nature of arbitrage. The study will not affect obligations issued prior to the date of this release.

More specifically, this ruling policy will apply to obligations falling within either of the following two categories:

1. Where all or a substantial part of the proceeds of the issue (other than normal contingency reserves such as debt service reserves) are only to be invested in taxable obligations which are, in turn, to be held as security for the retirement of the obligations of the governmental unit.

2. Where the proceeds of the issue are to be used to refund outstanding obligations which are first callable more than five years in the future, and in the interim, are to be invested in taxable obligations held as security for the satisfaction of either the current issue or the issue to be refunded.

The following are *examples* of transactions with respect to which no ruling will be issued:

First, a State may issue obligations and invest the entire proceeds in United States bonds with similar maturities bearing a higher interest yield. The United States bonds are then placed in escrow to secure payments of interest and principal on the States obligations. The profit on the interest spread accrues to the State over the period of time that these obligations are outstanding.

Second, a municipality may immediately realize the present value of the arbitrage profits to be derived over the future by casting the transaction in the following form: It may issue obligations in the amount of $100 million, use $20 million to build schools or for some other governmental purpose, and invest the balance, $80 million, in United States bonds which bear a higher interest yield. The United States bonds are escrowed to secure payment of interest and principal on the municipal obligations. The interest differential is sufficiently large so that the interest and principal received from the United States bonds are sufficient to pay the interest on the municipal obligations as well as to retire them at maturity.

Third, a municipality may issue obligations for the stated purpose of refunding outstanding obligations first callable more than five years in the future. During the interim before the outstanding obligations are redeemed the proceeds of the advance refunding issue are invested in United States bonds bearing a higher interest yield, and such bonds are escrowed as security for the payment of either of the issues of municipal obligations. During that interim period, arbitrage profits based on the interest spread inure to the municipality.

The Service made clear that this announcement covers only obligations falling within the two categories described above. Thus, for example it does not cover an issue of obligations where the proceeds are intended to be used to construct a facility even though the proceeds are initially placed in a trust for the security of the bond holders, and invested in taxable obligations, pending their use to meet the construction costs as they occur. Nor does it cover an issue of obligations merely because a portion of the proceeds is invested in taxable obligations and held solely to meet interest payments on the obligations pending the availability of other revenues.

STATEMENT BY THE HONORABLE SAM YORTY, MAYOR OF THE CITY OF LOS ANGELES, CALIFORNIA, TO THE UNITED STATES SENATE COMMITTEE ON FINANCE ON SEPTEMBER 25, 1969

SUBJECT: Objection to Provisions Relating to Tax-Exempt Status of Municipal Bonds in HR 13270

Provisions under Titles III and VI of HR 13270, which affect the tax-exempt status of municipal bonds, present a most serious financial threat to the City of Los Angeles, and I strongly urge this Committee to reject these proposals. These proposals constitute an unwarranted interference with the functioning of local government which has been given a constantly expanding role in serving the people of this nation. Furthermore, they come at a time when the larger urban centers are confronted with unprecedented demands for financing essential capital projects.

I am well aware that the motivation for this legislation was an attempt to provide a more equitable Federal income tax structure, but if such legislation will result, as I firmly believe it will, in enlarging the local tax burden of the people of Los Angeles and of depriving them of needed public facilities, then I must oppose it.

I will not attempt to cover all of the general and constitutional arguments against the adoption of these measures since these points have been or will be ably presented to you by others. My remarks will be directed at the effect of these proposals on the nearly three million people of Los Angeles (and the more than eight million for whom Los Angeles serves as the urban core and nerve center). Hopefully this view from Los Angeles will be relateable to other major population centers in the nation.

By way of background, let me state briefly that the City of Los Angeles has relied heavily on the municipal bond market in its rapid development since the close

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of World War II, and has issued over one billion dollars in general obligation and revenue bonds in just the past twenty years. With the assistance provided by this source of financing, the City of Los Angeles has built the nation's largest municipally owned utility providing the total water and electricity needs of the City, a new jet age airport--now the second busiest in the nation, the nation's foremost man-made harbor, a modern sanitation system, a world famous zoo, and many other significant public facilities.

How important has the tax-exempt feature of municipal bonds been to these developments? In the case of several projects, lower interest costs available through municipal bond financing provided the economic feasibility for projects which otherwise would not have qualified.

Lower interest costs on outstanding debt are the only obvious break the local property taxpayer receives. Local property taxes in Los Angeles have already reached a level where we are constantly seeking alternatives to reduce the burden.

Notwithstanding the volume of municipal bond financing the City has engaged in for developmental purposes, the practice has not been abused. The City's bonds by virtue of sound financial management have earned the confident support of bond rating agencies and are considered a prime credit in the municipal bond market.

I have seen statements emanating from Congressional and Treasury sources that indicate that the legislation now before you will not significantly affect the municipal bond market or raise interest rates on new issues. This is simply not true. As a matter of fact, the mere announcement by Chairman Mills early this year that his committee was going to consider legislation in this area, proved severely disruptive

to the municipal bond market. The uncertainty this generated as to the course Congress might follow in this field, caused all outstanding bonds in the municipal market to be discounted in value and drove many potential investors for future municipal issues from the market place.

Indices of interest rates on corporate bonds and municipal bonds, which historically tend to track one another, suddenly diverged. Acknowledging the difficult money market conditions that have existed this year, we still observed that the rate of increase in municipal interest rates has been more than 3-1/2 times that in the corporate sector. The increase in municipal borrowing costs in the first nine months of this year, as reflected in the indices, has been 26.3%, while costs of corporate borrowing moved up 7.4%. One announcement by the committee chairman, in the course of the committee's hearings, resulted in an historic 25 basis point rise in the municipal bond index in one day. On a $30 million issue of the City's water bonds such a rise in the bond index, equivalent to 1/4% on the interest rate, would have raised borrowing costs on the issue by more than a million dollars.

As further evidence of disruption in the municipal bond market, interest rates have now risen beyond statutory interest rate limits for several classes of the City's bonds. As a consequence, we have been unable to issue any airport bonds this year, when it had been our intention to issue approximately $170 million to finance necessary expansion of airport facilities. Millions of dollars in vital local improvement projects in the City have had to be postponed as a result of the effect this legislation has had on interest rates. The Department of Water and Power, which does not have a statutory interest rate limitation, has witnessed interest costs on its bonds increase 20% in the past nine months and interest costs on its short-term

borrowing jump almost 50% in the same period. Rates for water and electrical service to the Department's 1,600,000 customers must eventually reflect these higher interest expenses.

Looking to the future, our capital programs in Los Angeles were planned with a heavy reliance on the municipal bond market to provide needed funds. In the five-year period 1969-1974, the amount contemplated to be raised through municipal bond issues totals more than $1,600,000,000, broken down as follows:

Airport facilities	$ 710 million
Water and Power facilities	535 million
Recreation & Parks facilities	140 million
Library facilities	35 million
Sewer facilities	91 million
Parking facilities	20 million
Harbor facilities	14 million
Fire, Police and General Administrative facilities	35 million
District improvement projects	70 million
	$1,650 million

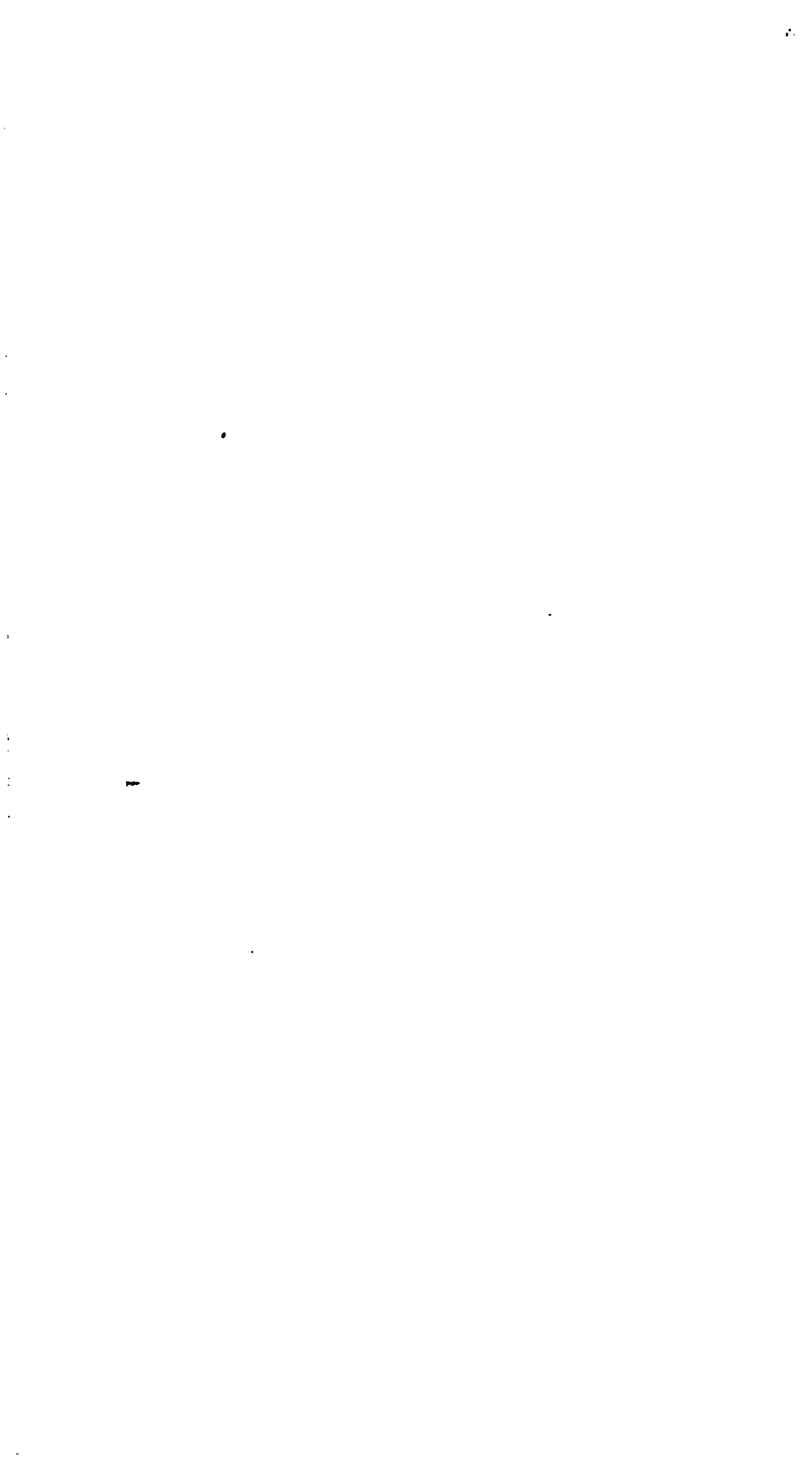
Increased interest costs on municipal bonds, which would be brought about by legislative changes governing the treatment of tax-exempt income in the Federal income tax structure, would obviously run into the hundreds of millions of dollars for the City of Los Angeles alone. This result, repeated in large cities throughout the nation would, if totaled, provide a clear perspective on the crushing burden to be added to the local taxpayer were the legislative proposals in Title III of HR 13270 to be enacted.

The City of Los Angeles must get on with the indispensable developmental programs that are required to provide a liveable environment for its burgeoning population. Title VI of HR 13270 purports to offer an offset to cities for loss of the advantages of issuing tax-exempt bonds should the cities elect to accept a Federal interest cost subsidy for issuing fully taxable bonds. Gentlemen, I have spent some time as a

member of Congress and know well the requirements to hold hearings, to examine evidence, to deliberate, and finally, to make a judgment on the worthiness of capital projects before granting approval for the expenditure of Federal funds. This proposal is simply not workable when consideration is given to the staggering volume of municipal projects which are needed and needed now. Decisions on what city projects are to be built in Los Angeles in what priority and how financed, are decisions that must be made in Los Angeles, not in Washington, D. C. This proposal runs counter to a growing awareness throughout the nation that government must decentralize in order to become truly responsive to the needs of its citizens.

The municipal bond market has been thrown into an almost chaotic state by Congressional actions relating to the treatment of tax-exempt bonds since the opening of this 91st Congress. The restoration of traditional investor confidence in municipal securities, will require a resounding rejection of the proposals before you. To quietly vote these proposals down or to refer them for further study, will leave the municipal bond market in the shroud that it has worn throughout this year.

The contention that proposals for legislation against the tax-exempt status of municipal bonds are an appropriate response to taxpayers' demand for tax reform will, I assure you, not set well with the people of Los Angeles; not when the people are made aware that the proposals advanced will significantly add to their own local tax burden and set up roadblocks to the progressive development of their City.



CONNECTICUT CONFERENCE OF MAYORS

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1ST VICE PRESIDENT — HUGH C. CURRAN, BRIDGEPORT
2ND VICE PRESIDENT — ALAN H. JEPSON, MILFORD
SECRETARY — P. EDMUND POWER, TORRINGTON
TREASURER — HENRY J. WOJTUSIK, BRISTOL

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DONALD T. DORSEY, MERIDEN
JOHN J. SULLIVAN, FAIRFIELD
ANTONINA UCCELLO, HARTFORD

PAST PRESIDENTS: RICHARD C. LEE, NEW HAVEN
FRANK N. ZULLO, NORWALK

Summary of Principal Points

Testimony of Mayor Paul J. Manafort of New Britain,
President of Connecticut Conference of Mayors,
testifying before the Senate Finance Committee
on H. R. 13270, Thursday, September 25, 1969.

Taxation of municipal bonds will add to already overburdened local property taxes. Increased interest costs will prevent use of local tax funds for other badly needed public services and facilities. Cities and towns should get more Federal and State assistance, instead of being penalized by taxing our bonds.

CONNECTICUT CONFERENCE OF MAYORS

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FRANK N. ZULLO, NORWALK

Statement of Mayor Paul J. Manafort of New Britain, President of the Connecticut Conference of Mayors testifying before the United States Senate Finance Committee on H.R. 13270, September 25, 1969.

The Connecticut Conference of Mayors strongly opposes Federal taxation of interest on municipal bonds. This exemption is essential, if municipalities are to provide badly needed public facilities and to prevent further deterioration of their serious financial condition.

Municipalities in Connecticut, as in other States, are trying hard to meet the pressing needs for schools, streets, sewers, and other public facilities. These needs are greatest in the older cities, which are attempting to catch up with years of neglect, and in the suburbs which must adjust to new growth.

The interest on bonds for such facilities is one of the largest items of local government expense. Interest on each million dollars of bonding costs us about $500,000 over the life of our 20-year bonds. Every rise in the interest rate adds to our local tax burdens, and impairs our ability to provide essential public facilities and services.

Connecticut's cities and towns face mounting costs daily. Debt service costs for urgently needed public facilities are already staggeringly high.

In Connecticut, for example, municipalities completed $60 million

in school construction projects last year -- projects taking care of some 35,000 additional children. The interest on these schools alone will be roughly $15 million to the cities and $15 million to the State. Add to that the libraries, roads, police stations, and other facilities we have built and need to build, and the cost is immense.

These costs are difficult enough for cities to meet. Taxation of municipal bonds will result in higher interest rates. Wall Street municipal bond experts advise us that communities now paying from 5 to 6½% will have to pay 8 to 8½% interest to compete with corporate bonds. Communities with weaker financial structures -- including some of those with the most difficult problems -- may have to pay as much as 10 or 11%. Municipal bond experts advise us that fear of the legislation before your committee has already caused a 1% increase in the rate at which municipal bonds are now selling.

Higher interest rates will mean higher local taxes, bearing most heavily on those who can afford it the least.

The situation is particularly difficult in Connecticut. Our municipalities are straining to find adequate sources of revenue. Yet our cities must rely exclusively on the overburdened property tax. The State of Connecticut pays a smaller proportion of our local costs than in 45 other states. The property tax bears the rest.

The Federal and State governments should be helping cities solve urban problems, not adding to our burdens. It is unfair to single out municipal bonds for "reform" while other tax loopholes continue to exist. We should be getting more financial assistance, instead of being penalized.

We therefore strongly urge you not to include taxation of municipal bonds in the bill your Honorable Committee will report.

A copy of the resolution passed unanimously by the members of the Connecticut Conference of Mayors is attached.

CONNECTICUT CONFERENCE OF MAYORS

101 LAFAYETTE STREET, HARTFORD, CONNECTICUT 06106 PHONE [illegible]

PRESIDENT — PAUL J. MANAFORT, NEW BRITAIN
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FRANK N. ZULLO, NORWALK

RESOLUTION

WHEREAS, local property taxes are much too high, and as a result, municipalities are unable to provide all the needed services, and

WHEREAS, increasing the cost of financing schools, sewers, streets, and other very badly needed public facilities, through taxation of municipal bonds, would aggravate the problem by leading to high property taxes and diminished municipal services, and

WHEREAS, the Connecticut Conference of Mayors believes that every American should pay his fair share of taxes, but

WHEREAS, taxation of municipal bonds will add further to the financial burden of all municipalities, and

WHEREAS, it is completely unreasonable to single out municipal bonds for "reform" while many other exemptions, favorable tax treatments, and loopholes will continue to exist,

NOW THEREFORE BE IT RESOLVED that the Connecticut Conference of Mayors vigorously opposes Federal taxation of interest on municipal bonds.

September 18, 1969

September 25, 1965

STATEMENT OF IRWIN KARP
COUNSEL, THE AUTHORS LEAGUE OF AMERICA
RELATING TO H.R. 13270, TAX REFORM ACT OF 1969

BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE, 91st CONGRESS, 1st SESSION

SUMMARY OF PRINCIPAL POINTS

Sec. 802 - The 50% Tax Limit

1. The 50% tax limit would not apply to authors, dramatists and composers under the present definition of "earned income", which is restricted to income from "personal services".

2. The 50% limit was intended to apply to income earned by a taxpayer's personal efforts - as distinguished from income produced by the use of capital. An author's income is "earned income".

3. "Earned income" should be defined to include income derived by an author from the disposition of rights to use his works [as in Sec. 401(c)(2)(C) (IRC)].

4. The 50% limit would provide a more equitable tax rate and would eliminate a formidable deterrent to independent creative work.

Sec. 311 - Income Averaging

1. Sec. 1301 (IRC) does not provide equitable taxation of an author when his income from one or two works, resulting from the creative effort of several years, is concentrated in the upper brackets of one or two tax years.

2. Section 1301 should be revised to permit the use of 3 alternative base periods for "income averaging"; the extent to which current income must exceed the average of a given period to increase in relation to the length of the period.

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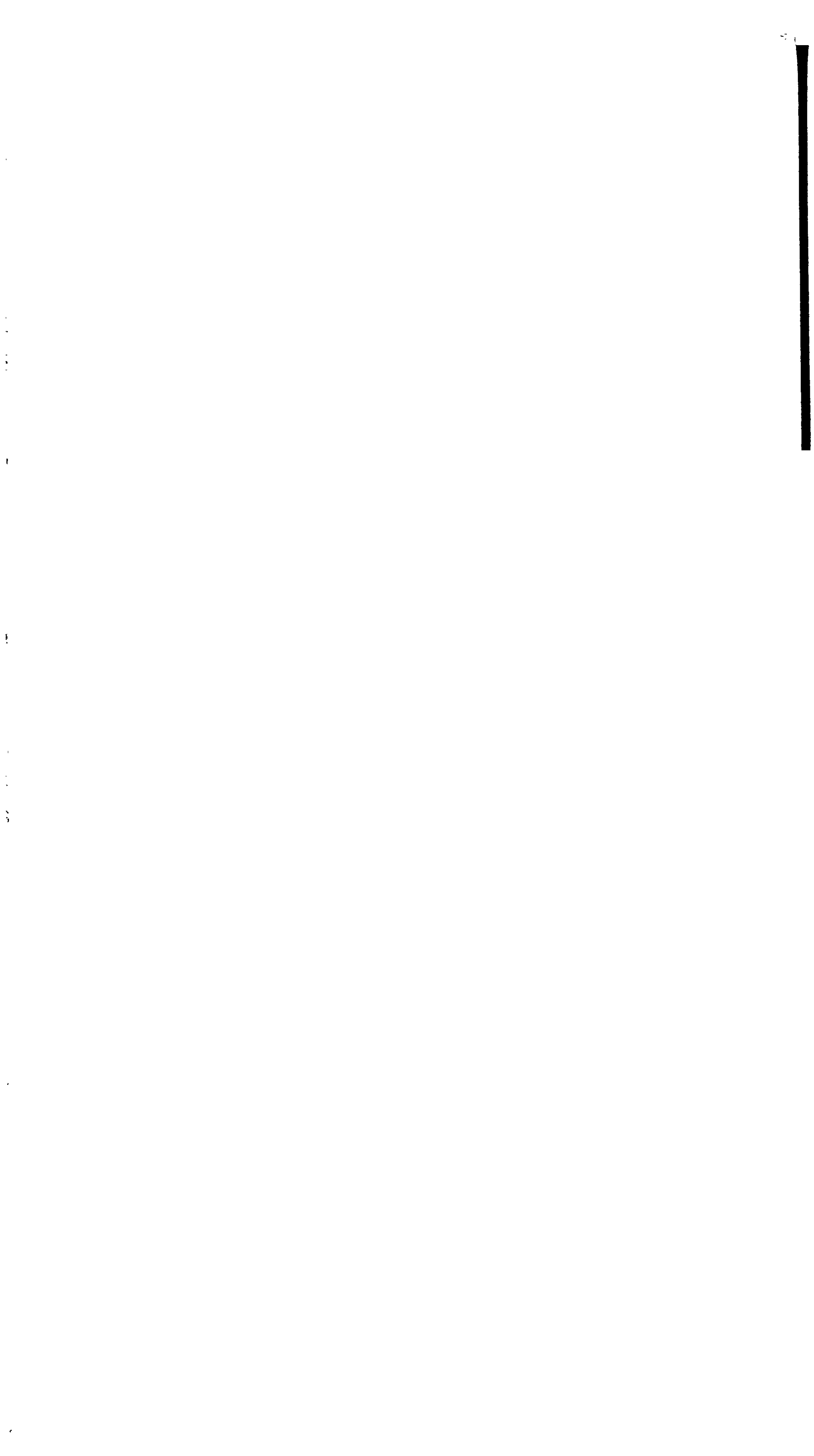

September 25, 1969

STATEMENT OF IRWIN KARP
COUNSEL, THE AUTHORS LEAGUE OF AMERICA
RELATING TO H.R. 13270, TAX REFORM ACT OF 1969

BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE, 91st CONGRESS, 1st SESSION

My name is Irwin Karp. I am counsel to The Authors League of America, a national society of professional writers and dramatists and submit this statement on its behalf.

The Authors League urges the Committee to extend the protection of the proposed 50% tax limit to authors, composers and dramatists. It also requests the Committee to consider revisions in the "tax-averaging" provisions which are described below.

Sec. 802 - The 50% Limit

Section 802 would limit the maximum tax rate on earned income to 50%. The Authors League believes that this maximum rate should be adopted. However, the proposed new section of the Code (Sec. 1438, IRC) would not - as written - apply the 50% limit to writers, dramatists, poets, composers, artists and persons in other creative occupations. They would continue to pay taxes ranging up to 70%, if their earnings were substantial. These individuals should not be taxed at higher rates than corporate executives and employees, lawyers and doctors, actors or professional athletes. Yet that would be the result, unless Sec. 802 is amended to include a more reasonable definition of "earned income".

We believe that the exclusion of authors from the 50% limit was inadvertent. The limit was intended to apply to income earned by a taxpayer's personal efforts - and not to income produced by the use of capital. However, to draw the line, a definition of "earned income" was incorporated from Sec. 911(b) of the Code. But that definition was formulated to serve the particular purposes of Sec. 911 which exempts income earned by certain non-resident citizens from tax. The Sec. 911 definition consequently limited "earned income" to salaries and other income from "personal services" - to confine the exemption to those citizens who are required to live abroad, i.e., those who earn their living by rendering services in other countries.

The Sec. 911 definition does not include other forms of income earned by a taxpayer's work and personal efforts, such as income earned by writing, composing and other creative occupations. Thus, while the Internal Revenue Service (and the Code) recognize that a self-employed author earns income by creating a book or play, it contends that this does not constitute income from "personal services" as that term is used in Sec. 911. Consequently, if Sec. 802 only applies to income falling with the Sec. 911 definition, authors will not be protected by the 50% limit.

Congress resolved the same dilemma in 1966 when it amended Sec. 401 (IRC) which permits self-employed taxpayers to make deductible contributions to retirement plans based on their "earned income". That Section originally defined "earned income" by incorporating the definition of Sec. 911(b). As this Committee noted, IRS took the position that a free-lance author's income was not compensation for personal services and therefore not "earned income". (Sen. Rep. No. 1707, 89th Cong. 2nd Sess.) The Committee said:

> ". . . The intent of the Congress in adopting the 'earned income' concept was to limit the applicability of these provisions to the portion of a self-employed person's income which was a result of his individual efforts as distinguished from a return on capital. Your committee does not believe that for this purpose the classification of income from an author's writing (or an inventor's invention), which is so clearly a result of his individual efforts, as 'earned' or 'not earned' should depend upon the terms of the contract under which the author (or inventor) is to be compensated."

Similarly, self-employed authors' income should be recognized as "earned income" under Sec. 802. It is as much earned by his work and personal efforts as are the fees paid to a lawyer or doctor, or the salary paid to a corporate executive, or the writer who works as an employee. The only difference is that the free-lance author translates his creative work into earnings by licensing or selling rights in his book or play,

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rather than by doing the work under a professional retainer, or an employment relationship.

The Internal Revenue Code classifies an author's earnings as income produced by his personal efforts; not as income derived from the use of capital. Sec. 1221 prohibits an author from treating his book or play as a capital asset; and denies him the right to claim a capital gain on any disposition of his work. Congress enacted this provision in 1950 on ground that an author's income was the result of his personal efforts and should therefore be taxed as ordinary income. (House Report No. 2319, 81st Cong.2nd Sess.)

We respectfully urge that Sec. 802 be amended to apply the 50% limit to income earned by self-employed authors (and by composers, artists and other creative persons) - i.e., the income they derive by licensing, selling or otherwise disposing of the works they create. This could be accomplished by inserting in Section 802 the additional definition of "earned income" contained in Section 401:

> "(C) - Income from disposition of Certain Property. -- For purposes of this section, the term 'earned income' includes gains (other than any gain which is treated under any provision of this chapter as gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property."

The Authors League believes that the 50% limit should be adopted. The present upper-bracket rates are "extremely high" and "unrealistic" (H. Rep. 91-413, page 208); and patently unfair to the individual who earns his income rather than derives it from "capital gains" investments. The rates impose a particularly heavy penalty on individuals such as authors and artists whose few years of high income are the result of many years of poorly compensated work. The tax averaging provisions of the Code, even improved as the Reform Act proposes (or as we suggest) cannot, in many instances, mitigate the confiscatory effect of these rates.

Furthermore, the present rates deter authors from independent creative work. Writing a book or play requires the self-employed author to expend a great deal of time (months or years) and money, to support himself and his family. If the work fails he loses everything; he has no loss deduction. The odds against success are high; free-lance writing is a high-risk occupation. Add to this the fact that if the book succeeds, as much as 70% of its earnings will go to the federal government in taxes (plus an additional slice for state tax), and it is understandable that some very talented writers frequently decide not to enter the contest.

It is much safer for an author to hire out to a motion picture company, magazine or other employer. He cannot write the

book or play he would have created as a free-lance. But his writing is guaranteed to produce salaried income, whether the work succeeds or fails. And the money he would have used to finance a free-lance work can be invested in securities. Even in today's market, the risk is less; and any gain would cost him 25% (plus surtax) rather than 70%. What we lose is the book or play he might have created had the tax rates not made risk of independent work so exorbitant, a book or play that might have enriched our culture.

The Authors League believes that the 50% maximum tax rate would remove this formidable obstacle to independent writing and provide a more equitable tax system.

Sec. 311 - Income Averaging:

Section 1301 of the Code was designed to eliminate unfair taxation of individuals whose compensation for several years of work is concentrated in one or two comparatively high income years. For example, the author who spends years, with little return, writing a book which produces substantial income in the year it is published. Or, the dramatist who creates several plays over a period of years, sees some score artistic success, but only has one that produces substantial income for a year or two. When the return for several years of work is concentrated in one or two years, it becomes high-bracket income, taxed much more heavily than if it had been received gradually over the period of work.

Section 311 of the Bill would liberalize Sec. 1301 by permitting current income to be "averaged" when it was 20% (rather than 33-1/3%) greater than average income in the prior 4 years. However, this improvement would not reach two areas of difficulty under the present section. The averaging formula imposes a tax on an individual's "concentrated income" which approximates the tax he would have paid had it been received ratably during the previous four years and the current year. But for some taxpayers, including many authors, the concentrated income represents the result of a much longer period of work. Limiting "averaging" to a five year period still produces harsh results; it does not leave such an individual with a fair share of "after-tax" income to compensate him for his years of work. Had the income been spread over the period of work, it would have been taxed at lower rates (often much lower than the 50% maximum of Sec. 802).

On the other hand an author may over a period of many years have only two successful works; but be unfortunate enough to have the second success occur within four years of the first. The income from the first work raises his four-year average to the point where he cannot apply Section 1301 to the windfall income of the second work and he is taxed at the high-bracket rates of the year in which the income was received.

To meet both problems, we respectfully suggest that Sec. 1301 be revised to allow an individual to elect one of three alternative "base periods":

> (i) if his current year's income exceeds his average annual income for the three (3) previous years by at least 20%, he may compute the tax on the excess as if it had been received ratably during the prior 3 years and the current year.
>
> (ii) if his current year's income exceeds his average annual income for the preceding four (4) years by at least 33-1/3%, he may compute the tax on the excess as if it had been received ratably during the prior 4 years and the current year.
>
> (iii) if his current year's income exceeds his average annual income for the preceding six (6) years by at least 40%, he may compute the tax on the excess as if it had been received ratably during the prior 6 years and the current year.

The length of the base period would depend on the extent to which current income exceeded the average for prior years. Since a greater increase is more likely to be the result of a longer period of work, this formula would produce a closer approximation of the tax that would have been paid had the income been received ratably during that period. In each case, the method of computation provided in Sec. 1301 would apply, adjusted for the number of years in the applicable base period.

Other sections of the Internal Revenue Code allow a taxpayer to choose between alternative methods of "receiving" income, and taking deductions, amortization and depreciation -

thus affecting the amount of tax to be paid. For Example: under Section 167 a corporate or individual taxpayer may select various methods of depreciation; under Section 451, they may report income on a completed contract or percentage of completion method; under Section 453, they may report income in the year a sale is made or over a period of years, on an installment basis.

We believe this change would provide more equitable taxation of self-employed authors, composers and artists, athletes, actors, musicians and others engaged in occupations where income fluctuates widely over a period of years.

Sec. 331 - Minimum Tax on Deferred Compensation

Sec. 331 of the Bill would place a minimum tax on deferred compensation for personal services. By its terms, the Section does not apply to periodic payments to authors under the "spread forward" provisions of publishing contracts; nor does the tax formula appear to have been drawn with any intention that it apply to such payments. However, if any changes are to be made in the Section which would effect payments under these contracts, we respectfully request the opportunity to submit a statement. The circumstances involved in such contracts are quite different from those involved in provisions for deferred compensation of employees; and imposition of the minimum tax on payments under these contracts would produce substantial inequities.

Respectfully submitted,

Irwin Karp

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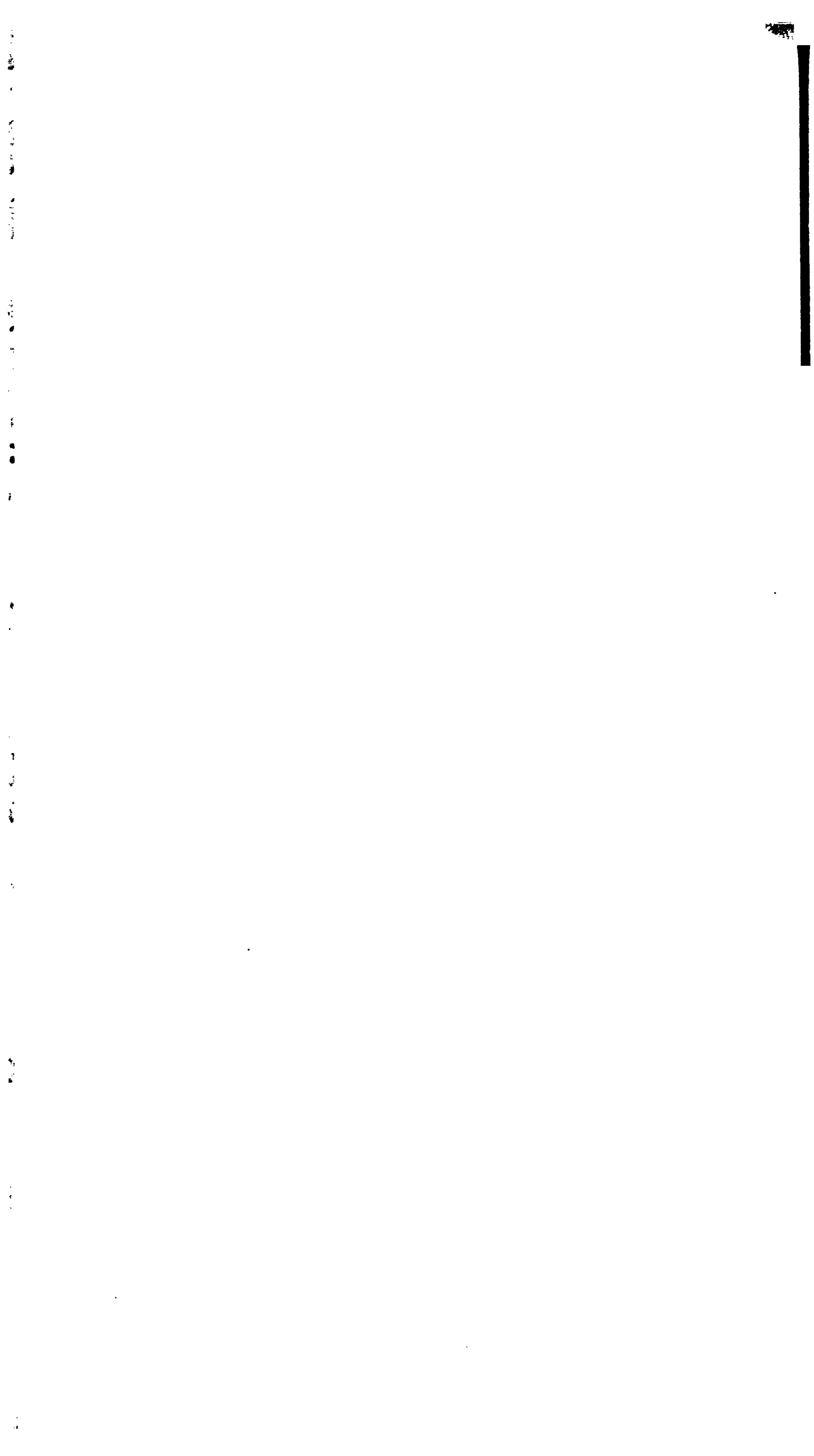

PART B—ADDITIONAL STATEMENTS

Statement by Governor Jack Williams of Arizona
Prepared for presentation to the Senate Finance Committee
Wednesday, September 24, 1969 - 10 a.m.

- -

Mr. Chairman, gentlemen, my name is Jack Williams and I am Governor of the State of Arizona. As the Governor, I am most concerned with the impact of certain provisions of the Tax Reform Act of 1969.

Arizona is one of the fastest growing states in the Nation in terms of population. Many new families move into the State everyday. Additionally, new businesses are developing within the State and many manufacturers have seen fit to locate additional facilities in Arizona. We welcome these individuals and firms to share our vision of the good life and the future of our State. However, their arrival creates a demand for additional public facilities and services. New highways, streets, sewers and water systems must be constructed. New schools must be built and existing schools expanded. Additional public facilities of every description are and will be needed to serve this expanding population base.

In Arizona, as in many states, such major public facilities cannot be constructed on a "pay as you go" basis. Existing operating revenues of the school districts, the cities, the counties and the State are not sufficient to permit this. Nor, if the example of major private enterprise may be taken as a guide, would this be sound management practice. Good financial management seems to involve the option, in certain instances, of borrowing to construct facilities as needs arise, and amortization of construction costs over a period of years. Governments in Arizona can become indebted--can borrow money--only through the issuance of bonds. The provisions of H. R. 13270 will have a substantial impact on the marketability and costs of municipal bonds. The interest subsidy program proposed under this legislation, in our view, is "too little, too late" and poses a number of problems, some of which go to the very heart of our Federal system.

Two provisions of H. R. 13270, the Allocation of Deductions Rule, and the Limit on Tax Preference, will have the net effect of placing a tax on municipal bond interest. We are advised that there are some constitutional questions surrounding this matter. It may be assumed that the constitutionality of this measure will be challenged in the court, resulting in lengthy litigation. During this time, the tax status of municipal bonds will be unclear and investors will be either unwilling to invest in these bonds, or will demand high enough interest rates to protect themselves against taxation. Turning aside for the moment from the questions of the cost and marketability of municipal bonds, legislation of this nature could create an inequitable

situation in which bond investors may reap a substantial windfall at the expense of local property taxpayers. If investors demand interest rates sufficient to offset possible taxation, and such taxation is later declared unconstitutional, those individuals who purchase municipal bonds will be receiving interest payments at a rate which would normally apply to taxable securities, yet those payments will be nontaxable, to say, this windfall will be subsidized by local taxpayers across the Nation.

As I indicated a moment ago, there are serious questions about the marketability of a taxable municipal bond. This is, in effect, a new form of security, and certainly will be in competition with corporate bonds. In the case of states, larger cities, and some urban counties and large school districts, the competition will be between municipal securities and top-rated corporated bonds. In our smaller cities, counties, and school districts, however, the competition will be between municipal bonds and second-ranking corporate securities. Few public agencies have a credit rating and repayment ability approaching that of major American corporations. The point here is that a taxable municipal bond is a new and strange entity in the market place, and will be in competition with bonds of a well-known character issued by large corporations with excellent credit ratings and established borrowing histories. We may find that under these circumstances investors are unwilling to purchase municipal bonds or will demand a very substantial premium for such investments.

The cost of borrowing by state and local governments is already high. In Arizona and in most western states, there are statutory limits on the maximum interest rate at which municipal bonds may be sold. In my State, we have now passed those limits in many cases, and certainly, if municipal bonds become taxable, our statutory limits will have to be revised. At best, this will result in the delay of needed public improvements until such time as the various state legislatures may act on the matter. Because of the uncertainty of the total situation, such legislative action may be substantially delayed.

In any case, it is obvious that the cost of borrowing at the state and local level will be increased. Anticipation of future taxation has already had its effect. The Bond Buyer's Index has shot up 70 points since July 18th when the House Ways and Means Committee made known its intention to tax municipal bond interest.

These increased costs have very significant and practical results for state and local governments. Let me give you just two brief examples:

1. The City of Phoenix recently initiated a street improvement district in the inner-city area. In the few months between the time of initiation of the district and the final call for bids, estimated costs of the project increased by 35 percent.

2. Maricopa County Junior College provides another example of this problem. On April 1, 1969, the college sold $5,000,000 of bonds at an effective interest rate of 5.037 percent. A second issue was scheduled for sale on September 22, however, this sale could not be made because of increased interest rates.

This increase in borrowing costs is recognized in H. R. 13270 and an attempt is made to offset it through an interest subsidy program. In order "to encourage states and their political subdivisions to voluntarily relinquish the privilege of tax exemption," H. R. 13270 provides for the subsidy payable either to the issuing jurisdiction or to its paying agent, ultimately ranging from 25 to 40 percent with the exact percentage to be determined by the Secretary of the Treasury on a quarterly basis. Although we understand that no review of the advisability of local projects or the ability of the issuing jurisdiction to repay is contemplated, we feel that such an element of review at the Federal level is almost inevitable. Action of this nature strikes at the very heart of our Federal system.

The matter is no less significant than that. Under our Federal system of government, the states and their political subdivisions exist as a matter of right, and not for the administrative convenience of the national government. Any action which weakens these entities--which limits their ability to discharge their proper and legitimate functions--weakens the Federal system.

Under the interest subsidy program, states and their political subdivisions would be wholly dependent upon the whim of the Federal government in a number of ways:

1. State and local indebtedness is on the increase and as the demands for new services and facilities increase, this indebtedness will increase. Local bond issues are now coming onto the market at the rate of 15 billion dollars per year and as I have indicated this rate is likely to increase. There is no assurance that appropriations will be adequate to subsidize all bonds issued.

2. When the demands for subsidy payments exceed the available appropriations, someone somewhere will have to make a decision as to which bond issues are to be subsidized and which are to be unsupported. All of our experience with Federal Aid programs, and the logic inherent in this system, lead us to believe that the determinations will be made by Federal employees, whose value judgments will supersede the decisions of local citizens who, through the ballot box, authorize the issuance of the bonds in question.

3. Given the above, the entire history of Federal Aid programs leads us to the conclusion that a broad range of considerations and criteria, certainly including national social policy, will be

employed in making such determinations. Thus, we foresee that ultimately the interest subsidy program will become as hedged with restrictions as are the various functional grant programs at the present time.

4. We have been told that the operation of the interest subsidy program will be "automatic." Assuming that this is true, and given the best of circumstances, i.e., adequate appropriations by Congress to fund all state and local bond issues subsidy payments, it will still be necessary to instigate certain administrative procedures to obtain these subsidies. Such procedures will, of necessity, be an added burden over and above the present procedures necessary for bond sales. This additional cost will be borne, in large part if not totally, by the states and localities.

5. As I have indicated previously, state and local bond issues will be in competition with corporate bonds, and will be viewed as less desirable in many cases than corporate bonds. We are advised by persons of considerable competence in this field that a normal spread between the prime interest rate and the interest rate on nontaxable securities should be approximately 50 percent. H. R. 13270, however, provides interest subsidy ranging between 25 and 40 percent. Thus, the interest subsidy will range from the marginally adequate to the inadequate.

In summation then, we are seriously concerned about the marketability of municipal bonds if H. R. 13270 becomes law, and about the cost of such bonds if, in fact, they are marketable. Additionally, we feel that the interest subsidy program, because of its implications for modification of the Federal system, is an unacceptable solution to this problem. The cure, in fact, may well be worse than the disease.

My statement, and the concerns it expresses, have the agreement and endorsement of the Arizona School Board Association, the Supervisors, the municipalities and the many irrigation districts throughout Arizona.

We urge that the traditional tax-exempt status of municipal bonds be preserved.

# # #

STATEMENT BY GOVERNOR NELSON A. ROCKEFELLER ON THE STATE - LOCAL BOND INTEREST PROVISIONS OF H. R. 13270 PRESENTED TO THE U. S. SENATE FINANCE COMMITTEE, MONDAY, SEPTEMBER 22, 1969

The interest on State and local bonds has long been exempt from Federal income taxation, but intergovernmental immunity in this area is not just a matter of traditional tax principle or technical constitutional theory. It is one of the cornerstones of sovereignty which enables state and local governments to fill their vital roles in our Federal system.

On April 10, 1968, before the Subcommittee on Air and Water Pollution of the Senate Committee on Public Works, and again on April 24, 1968, before the Subcommittee on Rivers and Harbors of the House Committee on Public Works, I expressed my unalterable opposition to the blanket denial of this traditional exemption on obligations which deeply affect the public interest. My concern, then and now, is that the withdrawal of this exemption, in whole or in part, would result in a dangerous unsettling of the delicate balance in our Federal-State-Local relationship.

I recognize that those who suggest elimination or modification of the exemption are motivated by concern over either Federal revenue not realized from exempt interest or the alleged disproportionate tax advantage which may accrue to holders of state and local obligations. But eliminating or altering the interest exemption, while alleviating the burden on the Federal taxpayer, would increase the burden of the state and local taxpayer as a result of the higher interest rates involved.

I realize, of course, that the pertinent provisions of H. R. 13270 do not involve a blanket elimination of the tax exemption. However, in addition to their inherent weaknesses and to the havoc they can wreak upon an already badly shaken municipal bond market, I am fearful that these proposals are a major first step toward total elimination of the exemption.

Apart from this general concern, I should like to make some observations concerning the specific provisions of H. R. 13270 affecting municipal bond interest.

Limit on Tax Preferences and Allocation of Deductions

Two provisions of H. R. 13270 directly affect the individual bondholding taxpayer, as well as estates and trusts. First, under the limit on tax preferences provision, no more than 50 percent of a taxpayer's total income (adjusted gross income plus tax preference items) can be excluded from tax. The tax preference items include tax-exempt interest on both old and new issues of state and local bonds to be accounted for over a 10-year period at a rate of one-tenth of the interest per year. Second, the allocation of deductions provision requires that an individual allocate his personal deductions between his taxable income and his tax preference items, to the extent that such items exceed $10,000. The tax preference items include tax-exempt interest on state and local bonds issued after July 12, 1969.

As contained in H. R. 13270, the combination of the limit on tax preference and allocation of deduction provisions seems certain to increase the cost of issuing municipal securities. There are two basic reasons, in my view, for the predicted increase.

First, there will undoubtedly be a legal test of the constitutionality of taxing municipal bond interest, at least under the limit on tax preference provision. In all likelihood the final constitutional decision will have to be made by the U. S. Supreme Court.

During the interim between the initial court test and the Supreme Court ruling, the municipal bond market would be in a state of uncertainty and the net effect would be a reduction in bond purchases by individuals. There may even be disinvestment in anticipation of an unfavorable court decision.

Banks and other institutional investors may also curb municipal bond purchases in fear that they may be next in line to have bond interest taxed.

Marketing bonds in the face of such uncertainty would necessitate higher interest rates to overcome the investor's reluctance to invest.

Secondly, a combination of the limit on tax preferences and the allocation of deductions provisions would reduce the net income from municipal bonds. This means that the after-tax interest

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differential between municipals and other forms of investment would also be reduced.

Individual investors will evaluate the differential in terms of whether or not it is great enough to warrant further purchases of municipals. In many instances, the decision will be to forgo buying state and local bonds. The market for municipals would be reduced and state-local government interest costs increased.

As John F. Thompson (Vice President of Morton and Co., Inc. of New York) said before a Municipal Finance Officers Association meeting in Toronto last May:

> .....tax exemption is not simply a gift from the Federal Government to certain investors. It is a quid pro quo for the acceptance of lower rates of return than the investor could obtain on alternative investments...An investor in tax-exempt bonds has accepted close to one-third less income than he could receive from taxable obligations -- that is what he has paid for the tax exemption. Thus, in a very real sense, and certainly in terms of equity, the investor in tax-exempt bonds has already paid his minimum income tax and he has paid it in advance.

To sum up, the impact of the two proposals, one directly taxing municipal bond interest income and the other indirectly

affecting the after-tax yield from such bonds, is to:

(a) Penalize the individual municipal bond investor;
(b) Reduce individual, and possibly some institutional, investment in municipals;
(c) Increase the cost of borrowing to state and local governments; and
(d) Pass on the increased cost of borrowing to state and local taxpayers.

Election to Issue Taxable Bonds and Interest Subsidy

A third provision of H. R. 13270 grants state and local governments the option of issuing taxable obligations. The resulting higher interest costs would be offset by a Federal subsidy ranging from 30 to 40 percent of the interest yield on bonds issued up until 1974, and from 25 to 40 percent thereafter.

Such a subsidy scheme, however, would give to the Federal government a dangerous degree of control of state and local bond financing. For Federal approval of a bond issue would be necessary in order for that issue to win a Federal subsidy.

Much of the support for a direct Federal subsidy on taxable municipal bonds rests on the argument that the revenue loss to the Federal Treasury stemming from the exemption of state and local obligations exceeds the interest saving on them and, hence, the present system is inefficient. For example, the House Ways and Means Committee Report accompanying H. R. 13270 estimates the annual interest saving in interest charges to state and local governments at $1.3 billion, while the estimated annual revenue loss to the Federal government has been estimated at $1.8 billion. It is then said that a more rational system would tax the interest.

Since Federal tax collections would exceed the increased interest cost, advocates of this proposal further contend that the Federal government could afford a subsidy and everybody would be better off. This is questionable.

High-bracket taxpayers, individuals, commercial banks and fire and casualty insurance companies, currently benefiting from tax-exempt bonds, might very well shift to other investment alternatives if some municipal bonds were made taxable and the offerings of tax-exempts were to become more limited and less attractive. Lower-bracket taxpayers, many life insurance companies and savings institutions, as well as individuals and non-taxpayers, such as pension and retirement funds and foundations, would be indifferent between taxable state and local bonds and other equivalent taxable investments. They might purchase the newly taxable municipals, or they might continue to buy tax-exempts, as dictated by their self interests. In effect, those interested in the tax-exempt market would be able to play a "heads-I-win: tails-you-lose" game with the Treasury. The resulting taxes collected might well be less than the subsidies paid. Furthermore, the administrative and fiscal problems involved in an optional approach would be enormous.

Such an arrangement would be unlikely to meet with Congressional or Treasury approval for too long. The temptation would be great to eliminate the option entirely and, perhaps, the subsidy as well.

The subsidy proposal actually has little or nothing to do with tax reform. Rather, its proponents are concerned with the adequacy of the capital market to supply the funds needed by state and local governments at low, reasonable interest rates.

Basically the problems associated with the total municipal bond market derive primarily from the general state of the economy and not from the tax exempt status of municipal securities or the amount of such obligations being placed in the market. Recently, for example, the primary problem has been the general inflation affecting the entire economy. Commercial banks, the major buyers of municipals, have sharply curtailed their purchases as a result of the Federal Reserve's anti-inflationary or restrictive credit policy. Federal monetary and fiscal policy achieving growth without inflation is the way to resolve the capital problems facing us.

* * * * *

While the condition of the economy has the greatest influence on the functioning of the municipal bond market, other factors also make themselves felt and the traditional exemption enjoyed by municipal bonds is a very important one. On August 3rd, shortly after the House Ways and Means Committee issued details on the then tentative reform bill, the New York Times reported the following reaction in the municipal bond market to the Committee's proposals:

> Tax reformers in Congress last week made sewers in Seattle more expensive, increased the costs of operating Alfred University and Pace College in New York State, and made it more difficult for Newark, New Jersey - the scene of one of the nation's worst racial outbreaks in 1967 - to borrow $12 million for new schools and $4.9 million for urban renewal.

In an ad placed by The Bond Buyer, the financial trade newspaper, in the New York Times on September 15, a $300 million increase in state and local borrowing costs over the past four months was attributed to the provisions of the House Bill. H. R. 13270 has already had an adverse effect on the municipal bond market. There is little doubt as to its ultimate impact should it become law.

At a time when so much emphasis is being placed on the "New Federalism" or on "Creative or Cooperative Federalism," it is ironic that we are seeing the attempted erosion of the traditional municipal bond interest exemption. The provisions of H.R. 13270 threaten the viability of our state and local governments and the delicate balance of our Federal System.

STATE OF NORTH CAROLINA
DEPARTMENT OF THE STATE AUDITOR
RALEIGH

September 23, 1969

HENRY L. BRIDGES
STATE AUDITOR

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

Subject: H.R. 13270, Tax Reform Act of 1969

Dear Senator Long:

Please accept this written statement in lieu of my appearance before your Committee in opposition to the portion of the Tax Reform Act of 1969 which relates to the tax exempt status of state and local bonds.

The levy of a Federal income tax on the interest received from state and local bonds would unquestionably curtail the ability of state and local governments to finance necessary public facilities. Direct, open market tax exempt financing is essential to responsible and efficient local administration. The level of government that is given the responsibility of raising revenues will assume the privilege of determining priority of expenditures and the role of the local official will become ministerial only.

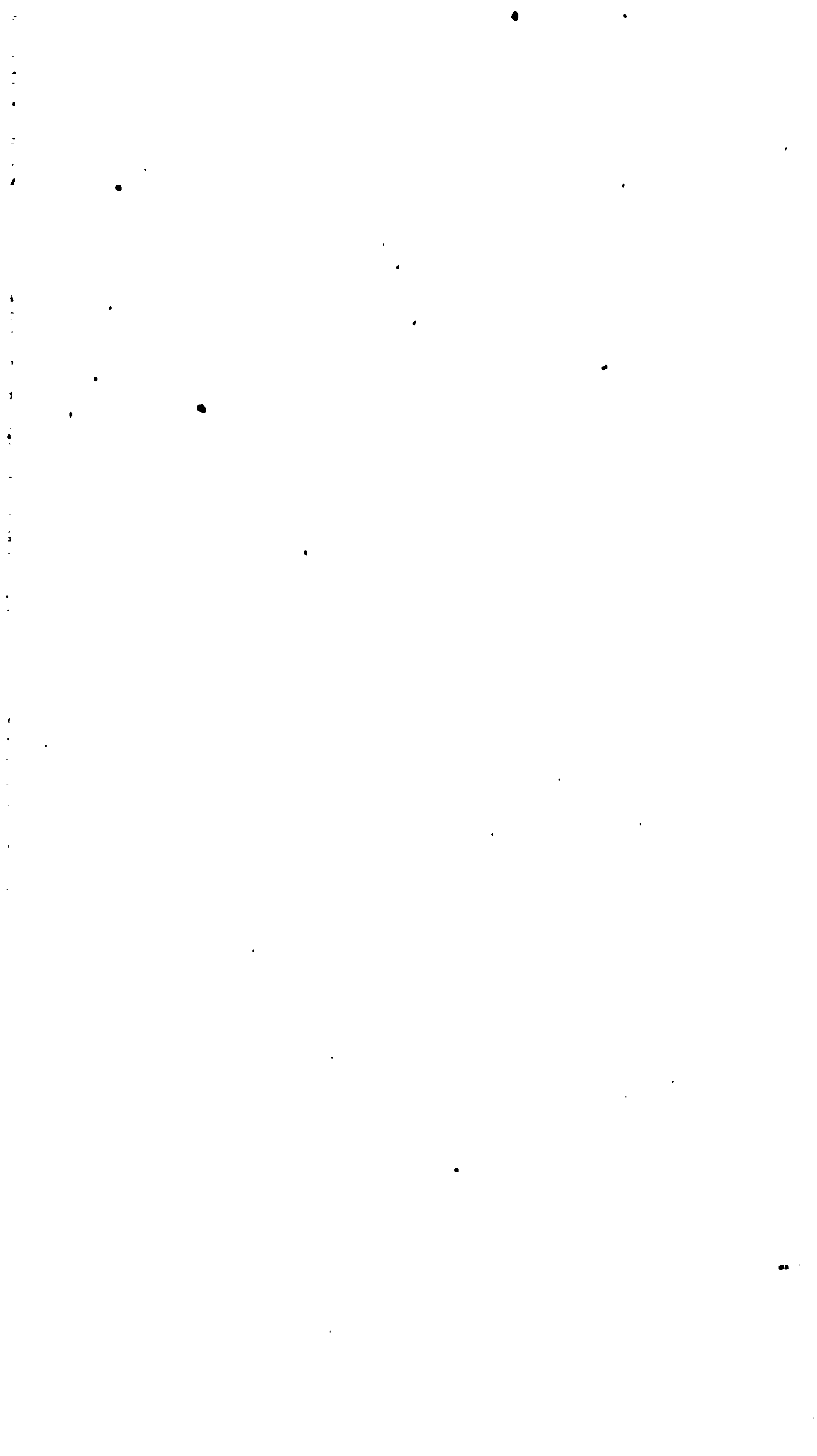
I therefore reaffirm my position of long standing that Congress should take no action which would remove the tax exempt status of state and local bonds or in any manner unsettle or destroy the functioning of the tax exempt market as an independent source of capital for local improvements. Also, I elect to rely upon the presentations and briefs of others having a common interest that the proposed tax levy is unconstitutional.

North Carolina and its counties and cities have historically followed the principle of pay-as-you-go, using borrowed funds only as and when absolutely needed. While I personally deplore abusing the tax-exempt privilege, I take pride in defending the policies and practices of our State's legislature in acting as guardian of public credit in North Carolina.

I offer the assistance of my office in providing you with further procedural and statistical information upon request.

Sincerely yours,

Henry L. Bridges
State Auditor



DETROIT-WAYNE COUNTY PORT COMMISSION

F. CLIFTON LIND
PORT DIRECTOR

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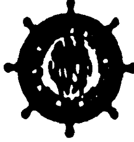


3210 GUARDIAN BLDG. DETROIT, MICHIGAN 48226

September 17, 1969

Senate Finance Committee
2227 New Senate Office Building
Washington, D. C. 20005

Attention: Thomas Vail, Chief Counsel

Gentlemen:

The Detroit-Wayne County Port Commission, the county agency vested by Michigan law with responsibility for the economic welfare of the Detroit-Wayne County Port District, wishes to file for the record of the Senate Finance Committee, in its current hearings on H.R. 13270, the following statement:

This Commission is strongly opposed to any attempt, directly or indirectly, to tax state and municipal bonds.

It is, therefore, unalterably against the passage of Sections 301, 302, 601 and 602 of H.R. 13270 for the following reasons:

1. The sections in question do not carry out the stated purposes of the bill.

Sponsors of the bill have repeatedly indicated that it is intended to close tax loopholes which presently cause great inequities in tax burden among various classes of taxpayers.

The Treasury Department claims that the tax exempt status of interest received by holders of state and

municipal bonds constitutes such a loophole. In an attempt to substantiate this claim it cites 154 cases of individuals, having incomes of more than $200,000 per year, who pay no taxes.

However, in every one of the cited cases, the tax-free status was a result of interest, charitable contributions and other deductions, not through holdings in municipal bonds.

Under today's economic conditions, the person who becomes free of tax liability as a result of placing all his funds in municipal bonds probably is a hypothetical fiction. An investor would have to be extremely naive to follow such a course, when he would be forced to accept approximately 30% less in interest from municipal bonds than good business judgment would require from comparably rated corporate obligations only to find that bonds which he acquired only a relatively short time ago at the then current interest yields, have suffered substantial declines in market value due to general interest rate increases in corporate bonds.

These sections would fail to carry out stated purposes of the bill for yet another reason.

The Report of Proceedings in the present hearings, September 4, 1969, P. 184 indicate that Treasury believes the application of Section 301 would net $45 million in annual tax revenue. The real effect would be to increase costs to state and municipal taxpayers by multiples of this amount each year. These increased costs would be required to be met by increases in local taxes. This would be neither equity nor tax reform.

Furthermore, these increased local taxes would be fully deducted on Federal Income Tax returns, resulting in a net loss to the Treasury.

2. If adopted, these sections would raise serious constitutional questions.

Most tax deductions are based on government policies which encourage philanthropy, stimulate needed investments, foster discovery of natural resources, and the like. Exemptions are the result of entirely different considerations.

In the case of municipal bonds, the exemption on interest received stems from the established constitutional principle of intergovernmental immunity. This principle has been followed throughout the nation's history in order to preserve the continued functioning of States and their political subdivisions in the stable framework of our Federal system of government.

If adopted, these sections would immediately raise constitutional questions as to the power of Congress to indirectly tax income from state and local obligations. They would inevitably produce litigation lasting anywhere from three to five years. Such litigation could be counted upon to thoroughly disrupt the municipal bond market which is already greatly hampered by the mere threat of passage of these provisions.

3. Adoption of the sections would have a crippling effect on the ability of state and local governments to fund capital projects.

State and local government construction of vitally needed schools, hospitals, water and anti-pollution facilities, streets, sewers and other public improvements would be made even more difficult, and, in many significant instances, impossible.

In a period when State and local governments are faced with tremendous problems of preserving and improving environmental conditions for an ever expanding population, the average taxpayer would bear a significantly increased burden if local governments are to continue to combat environmental problems. A great many of these taxpayers will find this burden unbearable, if they are employed in construction industries, because they will face unemployment as well.

In conclusion, we oppose the above cited sections because they would increase local tax burdens; because their proposal has already disrupted the municipal bond market and their adoption would bring utter chaos; because their adoption would destroy the ability of local governments to provide for public needs.

Adoption of these sections would entail the serious jeopardizing of a bond market which funds some $15 billion in public improvements each year, in exchange for an illusory $45 million gross tax revenue to the Treasury annually, which actually amounts to a substantial net loss after deductions.

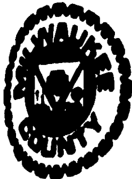
Adoption of these provisions would be infeasible, inequitable and, would not be tax reform.

Respectfully submitted

Detroit-Wayne County Port Commission

F. Clifton Lind
Port Director

FCL:ap



Milwaukee County

Milwaukee, Wis. 53233

RUDOLPH P. POHL
Supervisor, 20th District
1841 N. 73rd Street
Wauwatosa, Wis., 53213

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CHAIRMAN – COMMITTEE ON FINANCE

MEMBER
Metropolitan Problems Committee
Institutions Committee
Program Evaluation Committee
Fiscal Liaison Committee
Committee of Committees

September 19, 1969.

Senate Finance Committee,
2227 New Senate Office Building,
Washington, D. C.

Gentlemen:

We should like at this time to express our total opposition to any plan whereby the Federal Government infringes on the right of localities to issue tax exempt securities. This tax-exempt market provides us with an effective and advantageous vehicle for the financing of public capital projects and regard this financial independence as a significantly important feature of our federal system of government.

Investors in tax-exempt securities bought them in the belief that the income would never be taxed by the federal government. Once this principle is breached, there is theoretically no limit to the extent to which succeeding congresses could go. More than any other sector of the security markets, these bonds are based on the good faith of government at all levels. Any change in the tax status would not only result in higher initial interest cost, but irreparably damage investor confidence with far reaching effects on the cost of future local financing.

Federal tax exemption is not a gift to certain investors but really a concession made to the investor who accepts a lower rate of return than he could get in alternative investments. In a very real sense, the investor in tax exempt securities has already paid his income tax and done so in advance.

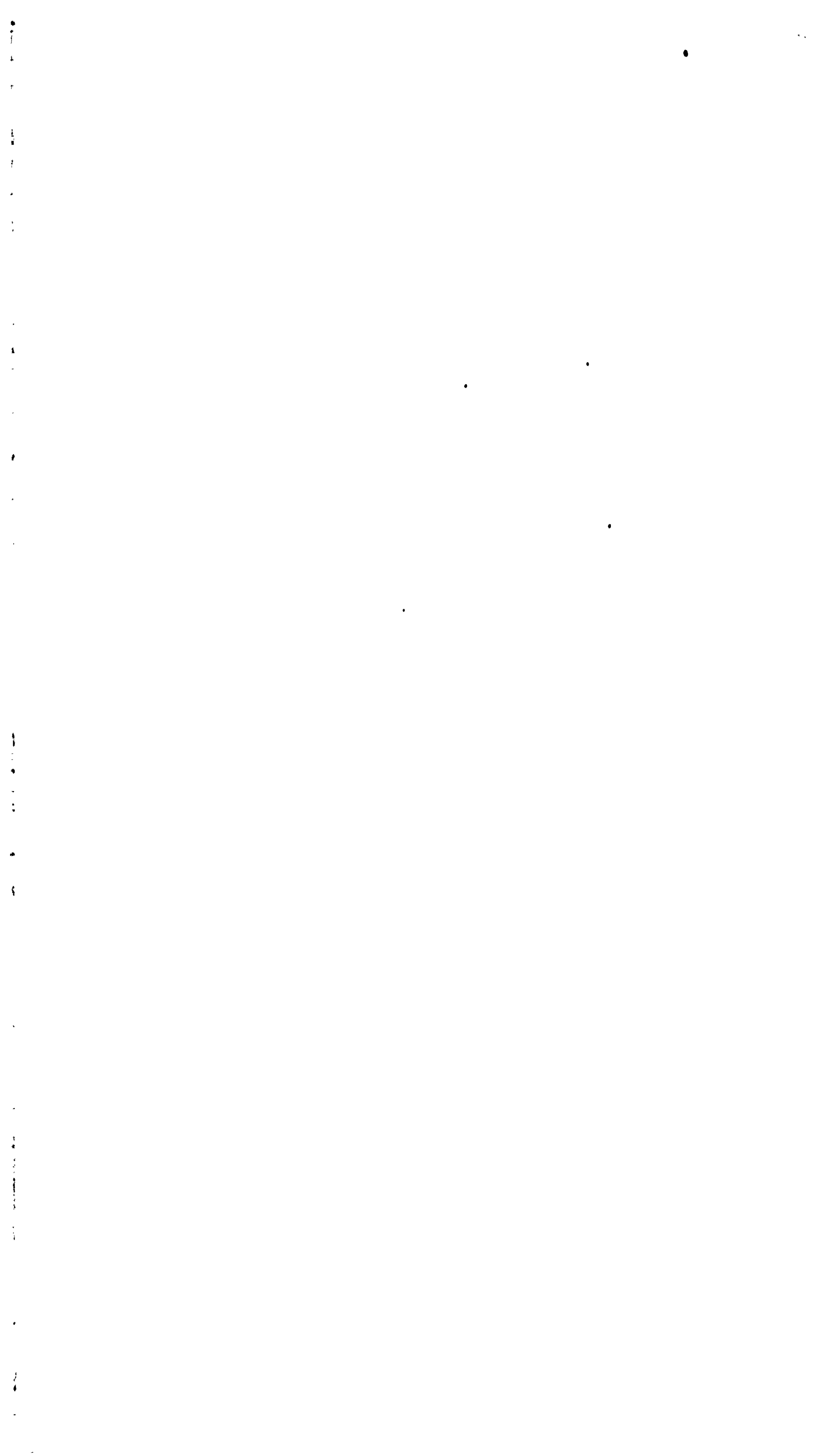
Presently, Milwaukee County is at the statutory limit for interest payments. Additionally, our property taxes are well beyond the reasonable limit of public endurance. We are now at the point of curtailing such things as parks, welfare and hospital programs. An additional burden of increased financing costs would force an even greater sacrifice in a time of impending urban crisis.

The County Board, by resolution and other actions, has fully endorsed this position.

Very truly yours,

Rudolph P. Pohl,
Chairman,
Finance Committee.

RPP/dmf



STATEMENT

In Behalf of

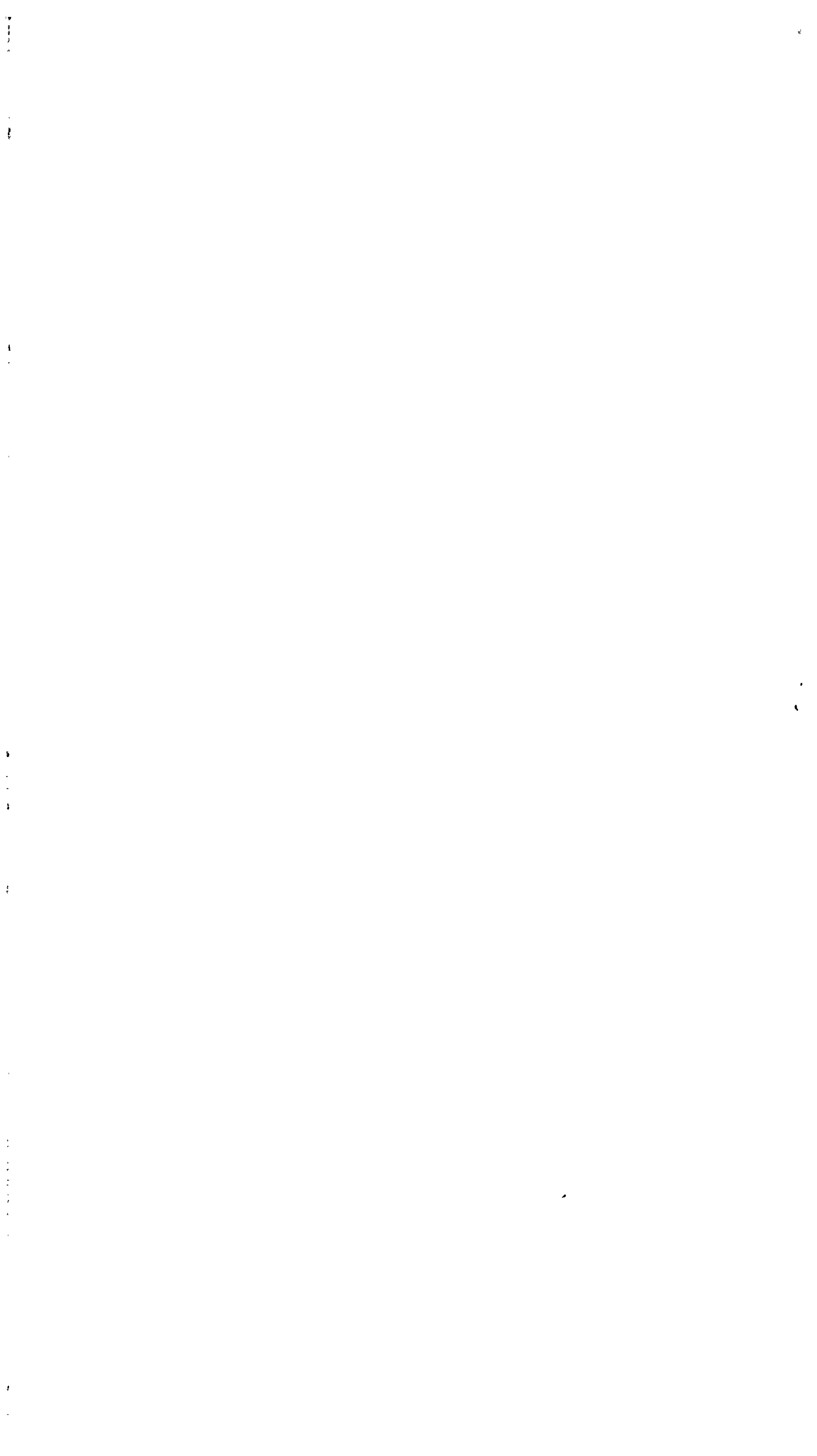
DALLAS-FORT WORTH REGIONAL AIRPORT BOARD

re H.R. 13270 — Proposed Taxation of Interest on Municipal Bonds

Submitted to the Committee on Finance
United States Senate

September 23, 1969

McCall, Parkhurst & Horton,
E. Ray Hutchison
Attorneys at Law
1400 Mercantile Bank Bldg.
Dallas, Texas 75201



STATEMENT re H.R. 13270
Proposed Taxation of Interest on Municipal Bonds

INTRODUCTION

H. R. 13270 contains essentially 4 provisions which directly affect the tax exemption on municipal bonds: (1) the provisions placing a "Limit on Tax Preferences" ("LTP"); (2) the provisions requiring an "Allocation of Deductions" ("AOD"); (3) The provisions declaring taxable the interest paid on so-called "Arbitrage Bonds"; and (4) the so-called alternative to tax exemption, the "Federal Municipal Interest Subsidy."[1]

Comment regarding the direct attempted elimination of the municipal tax exemption is probably by this time running into the hundreds of thousands of words. Comment on the indirect method of obtaining the same result through LTP and AOD is doubtless running into the tens of thousands. Most arguments against them have been stated and will be repeated and duplicated before this Committee, probably by many witnesses and in many written Statements, and some will be footnoted again herein. But, hopefully, most repetitious arguments will be avoided.

This Statement is not intended, in any sense, as a legal memorandum on the law of the subject, though a few cases will

[1] While great damage can be done by vesting in the Department of the Treasury unlimited jurisdiction to determine rules relating to municipal Arbitrage through the issuance of bonds, those provisions of H.R. 13270 will not be discussed herein except to urge that this Committee provide proper standards so as to assure the ability of local governments to invest public funds in Federal Securities. Additionally, the merits and demerits of the interest subsidy plan will not be discussed, except to suggest (a) that it really furnishes no alternative at all, and (b) that in any event the plan is not even legal under the laws of most States.

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be cited. As will be repeated herein, however, it is surely true that any Federal tax law calculated to increase taxes on account of the holding of municipal bonds will be the subject of years of litigation. Nevertheless, as a public agency and a party to the Constitutionally created partnership between the States and the Federal Government, the Dallas-Fort Worth Regional Airport Board proposes to speak, not in legal terms but in terms of the crisis to fall upon us all if these proposals or any akin to them become at least temporarily the law of the land.

The planned Dallas-Fort Worth Regional Airport is not typical, nor will it be just another airport. It represents an attempt to recognize that technology and usage in aviation and air transportation and commerce have overrun us – to the extent that airports throughout the Country are obsolete and many were so on opening day. The same is true also of the federally owned and financed airways system which connects airports throughout the Country. It is overcrowded and in many areas unsafe. The airports could barely be used, if at all, without the airways. The airways would be useless entirely without the airports. A true example of the mutuality of the need between two governments.

The only proven, feasible means by which a local government can finance its part of the cost of airport facilities is through the issuance of municipal bonds. Throughout the history of our governmental system, no other more workable means has been

[2] Two excellent legal presentations were filed with the Committee on Ways and Means on the Subject of the "Tax Treatment of State and Local Bonds": One, by the Honorable Francis O. Burch, Attorney General of the State of Maryland, and another by Mr. Northcutt Ely, Attorney at Law, Washington, D.C. Undoubtedly, both will be filed with your Committee.

devised. Indeed, none has even been proposed, and certainly none is contained in H.R. 13270.

The Dallas-Fort Worth Regional Airport will be owned jointly by the cities of Dallas and Fort Worth, Texas, and will become the regional center for domestic and international air commerce serving many parts of the world. Its planning spans over ten years and its first phase construction cost is estimated at $250,000,000. Its second phase, another like amount. That is, unless it is stopped, or becomes "typical or just another airport" through lack of funds. Yes, this facility faces a stoppage, a shut-down. It cannot foreseeably afford a 9% or 10% interest rate on its bonds through the sources of revenue it has available with which to pay them.[3]

By some standards, this project is small; by others, it is gigantic. By all standards, it is needed, in the interest of public safety, convenience and necessity. But in this reality, this project stands in no different shoes than the mass of other State and local projects throughout the Country which have aborted because of one simple fact of life – their financing is under attack in Congress. Their projects are of another nature, but equally as important.

Therefore, this Statement cannot properly be limited to the personal experiences of one airport in one area. Indeed, all States and local governments suffer. In this, then, the Dallas-Fort Worth Regional Airport is only representative and this Statement is submitted accordingly.

[3] By calculation, each 1% interest rate increase on Dallas-Fort Worth Regional Airport Revenue Bonds increases the cost of the airport by $86,723,000. Its last issue, December 1968, carried interest at 4.9%. It is now estimated that a 7½% coupon would be required. Thus, in 9 months, the interest cost increase alone virtually equals the debt needed to pay construction costs.

4

A Classic Miss of the Mark - *The Result: A Tax on Local Projects and Initiative*

> "Your Committee believes that no one should be permitted to avoid his fair share of the tax burden-*to shift his tax load to the backs of other taxpayers.*" Ways and Means Committee Report accompanying H.R. 13270, pg. 78. (emphasis added).

With this pronouncement, the Committee on Ways and Means proceeded to describe and recommend that the House of Representatives adopt a tax policy which calls for the levy of an indirect and sometimes direct tax (through LTP and AOD) on the interest paid on municipal bonds. The statement in its context is a classic example of missing the mark, of misleading, short-sighted and careless generality and incongruity. Surely a tax on municipal bond interest must represent the most obvious "pass-on" tax one could possibly describe or recommend. Without even so much as a ceremonial hearing on these provisions, sealed without substantive debate under the so-called "Closed Rule" of the House, the House of Representatives and its Committee on Ways and Means have succeeded in-

> tragically increasing the cost of State and local borrowing[4] to the point of shut-down in many instances and beyond the legal limits of many States;[5]

[4] According to the *Weekly Bond Buyer*, September 2, 1969, since July, 1969, when the Ways and Means Committee started serious consideration of these proposals, investment yields on new issues of local government "AA"-rated bonds had through September 2 risen by about 70 basis points (from about 5.50% to 6.20%), while yields on similarly rated corporate taxable bonds had risen during the same period by only 5 basis points (from about 7.95% to about 8%).

[5] For example, the Texas Legislature in March, 1969, enacted a law increasing permissible interest rates on local borrowing to 6-1/2%. On September 8, 1969, it became necessary that it pass a law removing all interest rate limitations. Else, except for a few, all local projects in Texas faced an involuntary moratorium at least until the Regular Legislative Session of 1971.

> wreaking havoc with the capital improvement planning and programs of State and local governments, including projects in process;
>
> displaying a calloused breach of faith through retroactive taxation of outstanding municipal bonds;[6] and
>
> challenging the very essence of our National, State and local governmental system, namely the constitutionally recognized principle of reciprocal tax immunity;

all without the benefit of logic and positive legal authority, and as a method of accomplishing the objective quoted above.

In this simple stroke of uninformed generality, under the guise of closing "loopholes" in the tax law, and in the ill conceived rush to burden one celebrated cause in the State of Michigan and 154 taxpayers (who did not utilize the municipal exemption to reduce taxes) with "their fair share of the taxes," the House and its Committee has inadvertently confirmed the genius and wisdom of Chief Justice Marshall when he said, in the often quoted statement·

> ". . . the power to tax involves the power to destroy."[7]

The municipal bond market has virtually ceased to exist, State and local projects and planning throughout the Country being left in the wake. Thus, unbelievably, at a time when State and local governmental units need so much in the way of funds in order·

> at least to abate, if not to solve, the crises in the Cities through improved public housing and other public facilities;

[6] Of all actions to date, this feature of LTP and the Administration's recently recommended treatment of AOD is perhaps the most unspeakable. Surely, a discussion of the point is not required.

[7] M'Culloch v Maryland, 4 Wheat (U.S.) 316,431(1819)

to avoid the pollution of the air and of the Country's rivers, waterways and harbors and to develop its water resources;

to repair the streets and road systems throughout the States;

to provide school buildings and facilities in order to avoid the present and continuing crisis in primary and secondary education;

to make an effort toward solving the problems of higher education in part through the construction and equipment of adequate buildings and facilities, including college housing;

to assist in the alleviation of the present and continuing crisis in air transportation and aviation by the attempted construction of adequate ground facilities at airports, in the interest of the public safety and commerce;

to provide for adequate recreation facilities, parks and park systems;

to provide hospital and care facilities for the sick, injured, infirm and aged; and

to provide at least the minimal, basic facility needs of citizens through adequate water, sewerage, storm, fire, police, public transportation and other facilities,

the States and their local governments are now, somehow, in this year of 1969, called upon to make a Statement in defense of their Constitutionally recognized power, right and duty to proceed with the job at hand, and to plead with the Congress of the United States not to destroy their ability to do so, or even to take the first step in that direction.[8]

It is unbelievable that the planners of State and local governmental projects throughout the Country, such as the

[8] "...It is obvious that taxation on the interest (on municipal bonds) would operate on the power to borrow before it is exercised..." *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. (1895), affirmed on rehearing, 158 U.S. 601 (1895).

18,000 acre Dallas-Fort Worth Regional Airport, could be praised for their vision in planning on the one hand by one or more agencies of the Federal Government, and be condemned by another agency of the same government (the Department of the Treasury) to the fate of paying a pass-on tax on those facilities if constructed according to those plans.

It is inconceivable that the Congress on the one hand would be considering proposals this very day to fund Federal and to assist in funding State programs to alleviate the problems of the Federal Government and of States, cities and schools,[9] and on the other hand, at the same time, be seriously considering a pass-on tax proposal under the name of "Tax Reform" which adversely affects and ultimately will destroy[10] the only successfully proven method of financing State and local self-help. If LTP and AOD or any law akin to them remain in H. R. 13270, then all Federal programs which depend on degrees of local self-help will be rendered meaningless, wiped-out, useless. Congress will have fallen victim to its own illusion.

It is inconceivable that the Department of the Treasury of the United States, an important arm of Federal Administration, could join favorably in this advocacy at a time when, under concepts of "New Federalism" and others, decentralization, local initiative and self-help are being advocated.

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[9] To name only two: At least a $5 billion Five-year airport facilities program, and a $10 billion highway program, not to mention programs for HUD, HEW, FHA and others.

[10] In a legal context, this Statement is speaking in terms of the Congressional "right" to tax, as distinguished from the "rate" of any tax on municipal bond interest. If a discussion on this subject ever degenerates simply to a question of "how much a tax will be," then the cause is lost. The Federal Government will be in complete control. Reference need only be made to the familiar argument that prevailed at the time of the initial proposal of the income tax in which some argued that a Constitutional limit of 10% should be imposed. This was considered absurd by others.

Many other things are inconceivable about the position in which we find ourselves. But such are the facts, unbelievable and inconceivable though they may be. The last chance lies in the Senate, with your Committee and the Conference that will follow, for, while unfairness and bad taste are not in order or intended, nevertheless, it does appear that the House of Representatives will adopt anything bearing the title "Tax Reform," and there are no present indications that the President would not sign it.

The unfortunate term "loophole" as used so frequently in connection with H. R. 13270 implies that the municipal tax exemption is a tax haven for the rich, or for those who are almost so. The above quoted objective of the Committee on Ways and Means, being sought in the removal or impairment of the tax exemption, must be tested by looking at the result to an investor in municipal bonds if the exemption is removed: Would he become less rich? In absolute and positive contradiction of the Ways and Means Committee, it is patently obvious that the answer is "No." He would serve simply as the conduit through which the tax would be levied and collected – from the very people the tax reform law was designed to assist.

Is there a difference because the tax may be discriminatorily indirect, such as through a requirement that ordinary deductions be allocated against the exempt income, as is provided in H. R. 13270? In this situation, it seems also patently obvious that this is a change in form only and that the results of a tax cannot be avoided by an attempt to hide it. Since the application of the tax depends upon the particular financial

[11] In the first place, this exemption finds its source, not in the Congress as a matter of Congressional grace, but rather in the Constitution as a matter of inherent right. *Pollock v. Farmers' Loan & Trust Co.*, supra.

circumstances of each individual purchaser of municipal bonds, it seems perfectly clear that the interest rates will increase across the board on all municipal bonds in order to protect the initial purchaser's prerogatives of resale and transferability, unencumbered by adverse tax rules as applied to various individuals as potential buyers.

The insidious characteristic, therefore, in both a direct and an indirect tax on municipal bonds is that the result to and the impact on States and local governments is the same: The change in the tax law relating to municipal bonds results directly and consequentially in an increase in the cost of State and local borrowing undertaken in the public interest in response to critical public needs, and in pursuit, at least until now, of recognized national goals and objectives. The House of Representatives and the Department of the Treasury are thus saying to States and local governments:

> "Proceed with your school buildings, your airports, your public housing projects, your water development plans, your pollution control programs, your colleges, your streets, your highways and your hospitals – but if you do you must pay (through local ad valorem taxation and charges) not only the normal cost of furnishing these facilities, but also you must additionally provide an amount to the Federal Government for doing so."

We submit that this additional amount,[12] pure and simple, is a direct tax imposed by the Federal Government upon State and local projects and upon State and local initiative, to avoid which

[12] How much the Federal treasury actually receives from this additional amount under an indirect tax is another question. Under the Treasury Department's recent proposal regarding AOD, the Federal Treasury will receive only $45,000,000 annually, according to Secretary Kennedy. It is suggested to the Committee that the personal deductions of increased ad valorem and sales taxes alone by reason of the across-the-board increase in interest rates will very likely produce a net loss to the Federal Treasury both under H. R. 13270 or the alternative proposed by the Treasury Department.

the State and local Governments simply do not build, grow and thrive of their own free will.[13]

The Question-
The unthinkable tax on a Partner

As stated earlier, it is not the purpose of this Statement to present the Committee with a legal memorandum or brief of the law on this subject. Obviously, it is a matter about which there is some difference of legal opinion. The Administration apparently is of the view that LTP is unconstitutional but that AOD is not. The Committee on Ways and Means apparently feels that both are legal. But one thing is for sure, the Constitutional question will be determined by the Courts if H. R. 13270 is passed in its approximate form.

What we hope to accomplish is simply to raise to the Committee what we consider to be the telling questions regarding this issue and the positions of the parties:

(1) Is it not just as unthinkable for the Federal Government to levy a tax (or adopt a tax policy having that effect) on an airport owned and operated by a State or local government, as it is unthinkable for a State or local body to levy a tax on a federal control tower at that airport or the federal airways system?

(2) Is it not just as unthinkable for the Federal Government to levy a tax on a State highway as it is

[13] The same thing can be stated in many different ways: The tax simply increases local ad valorem and other taxes and charges to the people who are supposed to benefit from "tax reform." Also, for those projects which simply are not feasible at higher costs, the obvious result is unemployment, further deteriorating public facilities, bankruptcy and the like. For the first time in recalled history, Congress will have been directly and solely responsible for a substantial, identifiable increase in local ad valorem taxes.

[14] As has been stated many times, this period of interminable litigation which perpetuates the doubt in investors as to their tax status, can have no effect other than the adverse continuance of the present financial crisis in States and their municipalities.

unthinkable for the State to levy a tax on the Federal highways running through it?

(3) Is it not just as unthinkable for the Federal Government to levy a tax on a State or local government hospital as it is unthinkable for a State or local governmental unit to levy a tax on a Federal hospital for the health care of veterans or others?

(4) Is it not just as unthinkable for the Federal Government to levy a tax on a State or local police building, a city hall or courts building as it is unthinkable for States and local governments to levy a tax on Federal government centers, post offices of courthouses?

Has the partnership between the Federal and State Governments, both joined together for the common good and for the benefit of the same people,[15] proceeded to the point of desperation where one of the partners seeks to increase the cost to the other of doing the public's business?[16] If so, is it not to be expected that the other partner will retaliate in kind and to the same degree? If it is Constitutionally permissible for the Congress of the United States to levy taxes (either directly or indirectly) on the interest paid on State and local bonds to the great and obvious detriment of those governments, is it not also true that State and local governments will be permitted Constitutionally to tax in the same manner the interest paid on the notes and bonds of the Federal Government, to its great

[15] While this is not an earth-shattering observation, we all deserve an occasional reminder that the same people constitute the citizenry of both governments, and it is their interest which we all seek to protect.

[16] "We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down what there is an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy what there is a right in another to preserve." *M'Culloch v. Maryland*, supra.

detriment and cost?[17] Is this not a classic case where neither government wins? Will it not, in the final analysis, lead ultimately to the dissolution of the partnership?

Won't the public be surprised when they hear it said, "All we were trying to do was close a loophole."

Respectfully submitted,

McCall, Parkhurst & Horton,
Attorneys at Law
1400 Mercantile Bank Building
Dallas, Texas 75201

By ....
E. Ray Hutchison

Dated September 23, 1969

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[17] "It is admitted that there is no express provision in the Constitution that prohibits the General Government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implication, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion?" *Buffington v. Day*, 78 U.S. 113 (1871)

SENATE FINANCE COMMITTEE HEARINGS ON H.R. 13270

STATEMENT OF CAST IRON PIPE RESEARCH ASSOCIATION
By: Edward D. Heffernan

My name is Edward D. Heffernan. It is a distinct pleasure and privilege to have this opportunity to appear before your Committee. I represent the Cast Iron Pipe Research Association, a group of nine manufacturers of cast iron pressure pipe A substantial proportion of the production of these companies goes into the many public waterworks around the country.

As you are aware, I am sure, Mr Chairman, most of the waterworks, either new or those being updated, are financed by the issuance of local bonds, the proceeds of which pay for the system Historically, the interest on these bonds has been tax exempt, thereby allowing these lower yielding securities a competitive place in the bond market. I need not dwell on the damage caused by the efforts to tamper with the tax exemption. It is all too evident in recent bond market reactions to the proposal you have under consideration Not as apparent is the vast number of water projects (destined to provide much-needed life support water systems to both rural and urban areas) which may well be jeopardized by a decision to go ahead with exemption-limiting provisions of H. R. 13270.

Our interest in opposing these provisions is both personally and civically motivated - personal, from the standpoint that our industry stands to be greatly impacted by a probable cutback in water projects all around the country; civic-minded, in that we cannot ignore the long-range potential for havoc in communities faced with critical water shortages in the face of burgeoning populations.

The bill proposes turning to the federal government as an alternative for help in financing the water systems. The supposed

election of choosing either a tax exempt bond or federally subsidized bond may turn out to be no option at all. The higher tax exempt bond interest rates would drive bond issuers to use the subsidy if the cost to them were cheaper. The economics of this will soon press every community into seeking the subsidy. Neither is it at all clear, given a predictable change in the market for taxable municipal bonds as opposed to tax exempt bonds, that the federal government would collect more money in tax revenues than it paid out in interest subsidies; in fact, there is much evidence to suggest that it would lose considerable amounts of money.

The Ways and Means Committee clearly indicated the concern of some members by stating in its report, "There is no review of the advisability of the local project or of the users' ability to repay. Despite this disclaimer, nothing was put in the language of the bill restricting the Treasury Department from setting up requirements, and, in truth, the bill gives the Secretary or his delegate broad discretionary power of regulation ("subject to such conditions as the Secretary or his delegate, by regulation, prescribes"). Annually, it will be necessary to go for appropriations, and thus changes are always a possibility. Obviously there was discussion of the specter of federal controls when a community accepts federal assistance. Our concern here is that when it comes to setting priorities for worthy projects to be funded, the local people most familiar and closest to the problems will be subordinated to the bureaucratic review. Water needs, not nearly as glamorous as many publicized national problems, will be pushed far down the list of priorities. We do not think it is wise, equitable

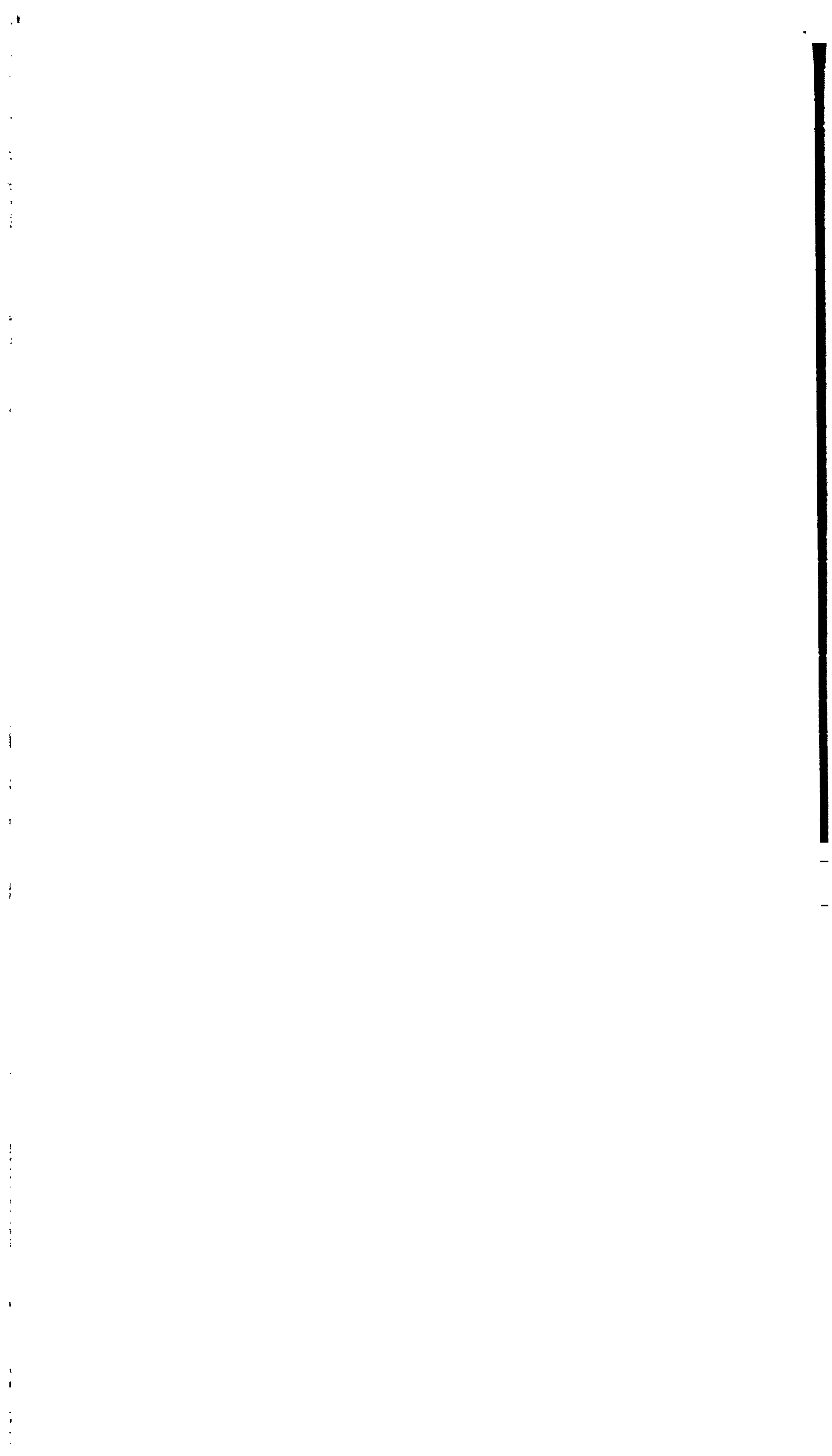
or economically sound to put the business of providing clean water on a constant crisis basis, and yet we are concerned that the passage of H. R. 13270 in its present form will do just that.

Our comments have been mainly about the election provision for state and municipal bonds; however, several other provisions of H. R. 13270 will have an objectionable effect on tax-free local bonds. The allocation of deductions provision includes the interest from new municipal bond issues in the list of tax preferences against which an individual would now have to charge a portion of his deductions. The limit on tax preferences requires that one pay taxes on at least half of all his earnings regardless of source (which includes interest from state and local bonds). The attraction of municipal bonds on the open market would certainly be impaired by these provisions.

Another aspect that greatly concerns us is the constitutional issue inherent in this legislative provision, since the federal government would be taxing a portion of the interest from tax exempt municipal bonds through the limits on tax preferences mechanism. Undoubtedly, opponents will challenge the constitutionality in the courts, resulting in lengthy litigation. During this period of doubtful tax status, bond investors would be unlikely to invest until the issue is resolved. Thus, with the market for bonds totally disrupted, many or all water systems projects would have to be suspended.

We urge you to remove these onerous provisions affecting local tax-free bonding and let our cities and local governments get on with the job of renewal, unhampered by unwise legislation hastily drawn in the name of tax reform.

Thank you for your consideration.



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STATEMENT OF THE EXECUTIVE COMMITTEE OF THE LEAGUE OF MINNESOTA MUNICIPALITIES BEFORE THE SENATE FINANCE COMMITTEE CONCERNING THE TAXATION OF MUNICIPAL BOND INTEREST - September 23, 1969

The Executive Committee of the League of Minnesota Municipalities would like to express its opposition to those provisions of the Tax Reform Act of 1969 (H.R. 13270) which would result in the direct or indirect taxation of the interest on municipal bonds. Specifically, we are opposed to the provision of this bill which includes the interest from municipal bonds in the proposed allocation of deductions rule and the provision which includes the interest from municipal bonds in the proposed limit on tax preferences.

Our opposition to these specific provisions of H.R. 13270 should not be construed as opposition to the general objective of introducing a greater degree of fairness and equity into the federal income tax. We are fully aware that the sentiment both in the Congress and among the public at large is strongly in favor of tax reform and we are in sympathy with these views. However, with the interest rates on municipal bonds at the highest level in one hundred years, we must oppose the inclusion of the interest on municipal bonds in these two provisions of the bill because enactment in their present form would almost certainly have the effect of increasing the interest rates on municipal bonds even further.

If, despite the opposition of municipal officials, the Congress in its wisdom determines that the interest on municipal bonds should be included in the allocation of deductions rule and/or the limit on tax preferences, then we strongly urge

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that the proposed bond interest subsidy program for bond issuers who waive their tax exemption be retained in the bill, including the provision permitting the issuance of dual coupon bonds. This latter provision would be absolutely necessary in Minnesota in order to avoid violation of the state statute which limits the interest which can be paid on obligations issued by its subdivisions to 7% per annum.

DAL: 9/22/69

SUMMARY OF Principal Points of Statement by Rollin F. Agard, Financial Consultant, Aviation Department, City of Kansas City, Missouri, to United States Senate Committee on Finances, September 23, 1969, re: H.R. 13270.

1. This legislation destroys the market for securities now tax-exempted.

2. Any subsidy granted by Federal Government must be tax supported from local residents and business.

3. Revenue derived from taxing this bond interest will not offset cost of subsidy and higher rate costs.

4. Raise serious question concerning claim that there will be no federal review of local projects financed by taxable bonds.

5. Subsidy could be, in effect, a blank check on U.S. Treasury and by controlling this, U.S. Government controls local financing.

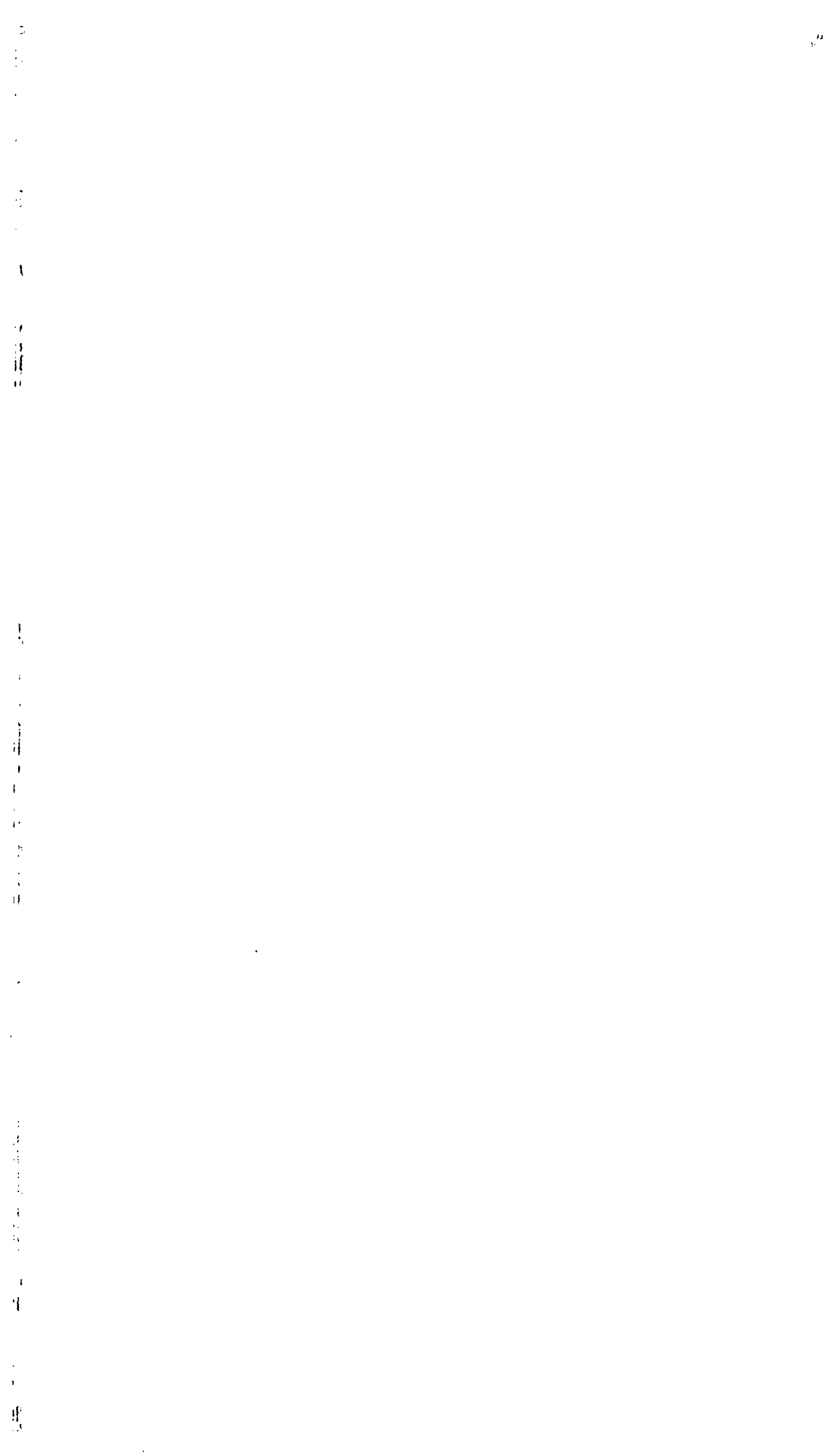
6. Cost of administration federally and locally would be substantial.

7. Prospects of passage of this legislation has effectively destroyed the market, both primary and secondary.

8. Twenty-four states limit interest rates to 6% or below on General Obligation Bonds, six states limit interest to 7%, and twenty states limit interest to 6% on Revenue Bonds.

9. There is a question in some states whether taxable bonds can be legally issued.

10. No time to be tampering with the right of local government freedom to finance its needs.



Statement by Rollin F. Agard, Financial Consultant, Aviation Department, City of Kansas City, Missouri, to United States Senate Committee on Finances, September 23, 1969, re: H.R. 13270.

"While the bill before this committee permits states and municipalities to continue with the issuance of tax-exempt bonds, the same act practically destroys the market for a tax-exempt security. The alternative of a Federal interest subsidy holds no assurance that such a plan will continue to exist. It will only be a matter of time before the legislation is changed in the press of events that no further subsidies will be granted on future municipal issues.

"I think it is well to point out that any subsidy granted by the Federal level for municipal bond interest must be supported from taxes which originate from local residents and business. I believe very strongly that the cost of financing under the proposed legislation will be substantially greater than before. The income to be derived by the Federal Government from the taxable securities will by no means offset the subsidy and the higher rates that the municipal portion of the bond package would require.

"Proponents for this legislation have advocated that there would be no Federal review of local projects. I find it difficult to accept this viewpoint. This has the effect of writing a blank check on the Federal Treasury for the sum of the subsidy to be provided from that source. The Federal Treasury is not a bottomless pit, and each session of Congress must, if this legislation is passed, appropriate the needed sums for the subsidy payments. There is little question but that eventually all local initiative would be a thing of the past. The cost at the Federal level for administration of such a program will be substantial as

well as less effective than now exists. Also, the administrative cost at the local level will be much greater.

"Events of recent months reveal the seriousness of impairment of the municipal market resulting from congressional action to this date. Hundreds of municipal bond issues have been grounded because of interest rates which would exceed legal limits. For those issues which could be marketed, the cost to the taxpayers will run into many millions of additional dollars. Each week many bond issues have failed to obtain voter approval. Only recently the voters of Texas refused to approve an increase in the interest ceiling.

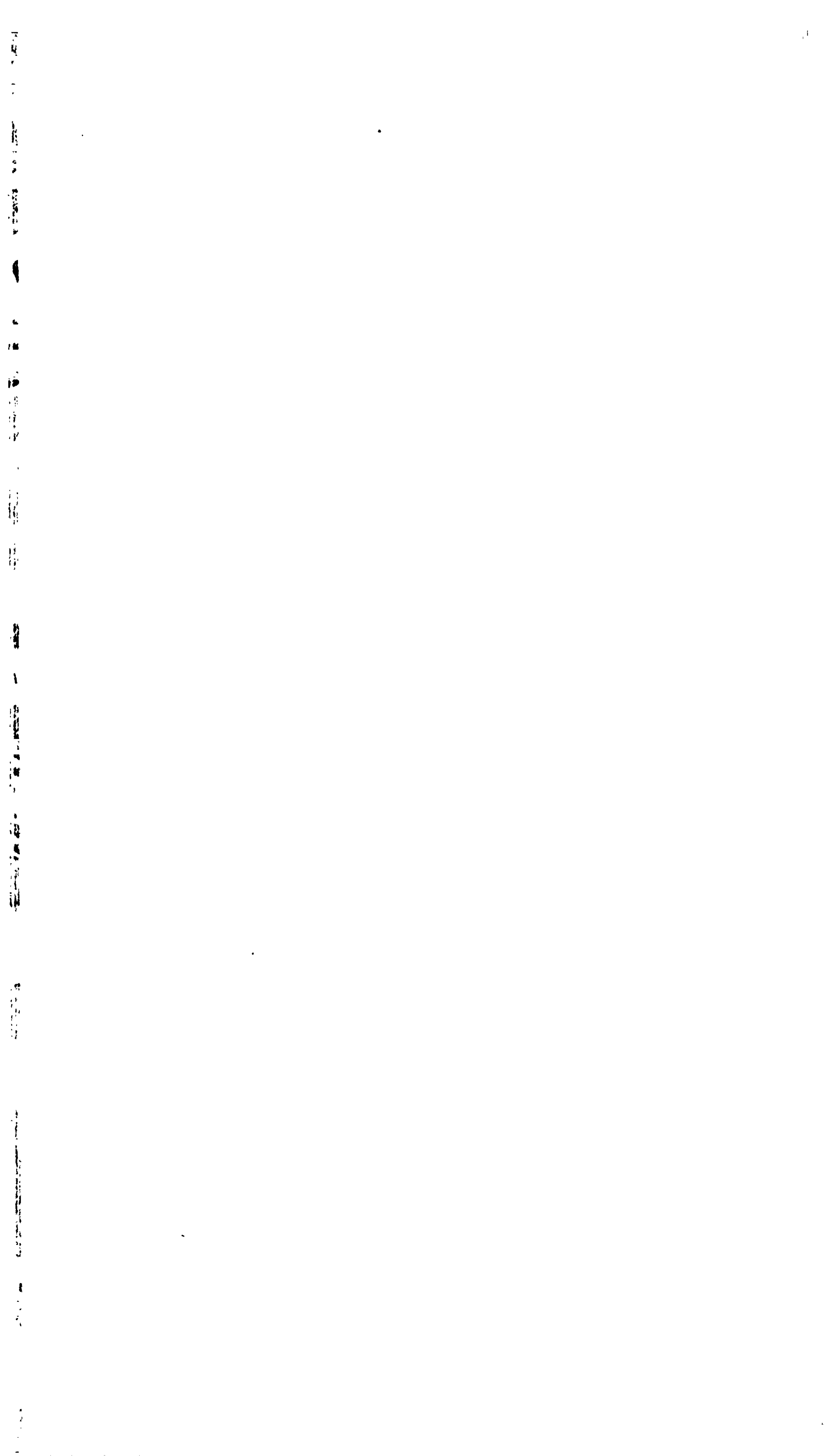
"The August 25, 1969 issue of the Daily Bond Buyer published information showing that in twenty-four states, statutes set interest rate ceilings at 6% or below for general obligation bonds. Six other states have a limit of 7%. For revenue bonds twenty states have a 6% ceiling. Moreover, the charters of many cities establish interest rate ceilings as is the case in Kansas City. Ordinarily, charters can only be amended by a vote of the people.

"The impact of this legislation has thrown the secondary market into a state of chaos. This phase of the municipal bond market has become increasingly important, with the municipal debt now at about $130 billion. Thousands of bond holders, many of whom do not fall in the wealthy levels of our society, are seeing their lifetime savings being depleted by as much as 25 to 30%. This is destroying the faith of investors for municipal bonds. It is one of the major factors that have caused the interest rates to spiral in recent months to levels never before experienced.

"If this bill is approved in its present form the Federal Government may find itself in the bond business, thus destroying another phase of this nation's private enterprise system.

"There could also be a question in some of the states as to whether any municipality has the authority under the constitution and laws of the state, to issue taxable bonds without an amendment of the state constitution and the bond laws of the state.

"In light of the serious need for local improvements to provide essential facilities for an expanding nation, this should not be the time for tampering with the local financing systems. America is great because it has had local freedom. If this is traded for a powerful central government we are doomed for destruction. If the tax-exempt status of municipal bonds is removed, a long period of litigation is inevitable. This, too, will stifle progress at the local level and could endanger the National economy."



STATEMENT ON H.R. 13270

BEFORE THE SENATE FINANCE COMMITTEE ON SEPTEMBER 25, 1969, BY PATRICK H. RENSCH, SPECIAL COUNSEL, CITY OF NORTH PLATTE AND LANFORD L. JORGENSEN, ADMINISTRATIVE ASSISTANT TO THE MAYOR OF NORTH PLATTE, NEBRASKA

Mr. Chairman and Members of the Committee:

The Mayor and Council of the City of North Platte, Nebraska, have gone on record as strongly opposed in principal to any language in H.R. 13270 or any other Bill which would in any way directly or indirectly tax the income of any bonds or obligations of any State, or any governmental subdivision of any State. They also have gone on record opposing any language in H.R. 13270 or other legislation which would in any way establish voluntary relinquishment by a State or subdivision thereof of the tax exemption for any reason, whether it be subsidy, aid grant or control. They have also gone on record as being opposed to any language in H.R. 13270 which might relate to the subject called arbitrage which in any way would give the federal government a right to question legitimate financing plans or programs, whether required to be in the form of advance refunding or other programs where the only logical investments, or the only legal investment, might be an interim investment in United States government bonds. This written statement is a brief summary of these objections and some of the reasons for the objections.

This statement is made not only on behalf of the City of North Platte, but is authorized to be and is presented as the official expression of the School District of North Platte and of the Mid-Plains Area Vocational Technical School, a multi-county vocational technical school district is Western Nebraska, and that reference hereafter to the official body of North Platte, we refer also to the other political subdivisions above mentioned.

First let us say that we do not believe that the inclusion of the taxation of the income of municipal bonds in H.R. 13270 is tax reform. We consider it to be more in the nature of the political or constitutional reform under the guise of tax

legislation. We feel it is unconstitutional and we feel that it is politically and fiscally unwise in that its consequences, in addition to being a more costly method of financing municipal improvements, involves a threat to the whole concept of the separation of the powers of the federal government and the States and their subdivisions.

We believe in the principal of the separation of the powers between the Federal Government and the States as provided for in our constitution and as they have developed under the laws of the United States Government and the decisions of the United States Supreme Court. We recognize that the present ability of States to sell bonds at a rate which is competitive with the cost of financing of the federal government is probably the biggest single factor today in retaining the principal of the separation of the powers of the federal government for those of the state local government. We feel that any change in the nature of this relationship will only lead to more and stronger centralized federal control over matters which are rightly within the prerogative and the concern of the State and local governments. We feel that the right of taxation of municipals is politically and financially unsound and will ultimately lead to chaos in the municipal bond market, will lead to higher financing cost and ultimately to the assumption by the Federal Government of the function of financing of the local improvements resulting in the loss of local control and decision making.

We feel that the passage by the House of Representatives of H.R. 13270 shows a lack of understanding of this concept not an intent to change our constitutional birthright which is subject to ultimate termination by the logical extension of this legislation. We know that the impression which has been given by publicity in the national news media from statements made by those espousing the taxation of municipals are misleading and that the true picture of the problems involved has not been recognized, possibly because of this. You should recognize that our bonds are purchased by those in an income tax bracket which makes the purchase of our bonds advantageous to them - the margin is thin. To say that the purchaser of a municipal bond does not

pay a tax is grossly in error. When an investor buys a North Platte bond with a tax free rate of 4%, whereas he could buy a taxable bond of similar quality for 6%, he pays directly to the city whose bond he purchases a tax of 33% since his return is one-third less. The treasury department in their proposals acknowledge that this difference may be between 30% and 40%.

We have here an ingenious system for the return of tax dollars to municipalities which preceeds and complements announced plans for returning tax dollars to cities and states. In one sense the city whose bond is purchased receives a tax from the purchaser in the form of reduced interest. Without developing a bureaucracy or creating other problems we have one solution, the return to the local government of federal income taxes, which should be expanded, not curtailed. The publicity concerning about 150 to 200 millionaires who do not pay taxes was unfortunate and inaccurate as it relates to municipal income.

Title III, Section 301 of H.R. 13270 makes possible a direct income tax on the income from municipal bonds owned by individuals, estates and trusts in that tax preference income will not be permitted to exceed one half of the total income and the taxpayer will be required to pay tax on the remaining half (in case of taxpayers with total tax preferences in excess of $10,000). This applies equally to outstanding bonds as well as new bonds and is hereafter referred to as "limited tax preference".

Title III, Section 302 H.R. 13270 would in certain instances deprive taxpayers of their present ability to deduct fully the amount of personal income tax deductible against their taxable income. This does not apply to bonds issued prior to the specified date. This will hereafter be referred to as "allocations of deductions".

Title VI, Sections 601 and 602 H.R. 13270 - There is provision for a State or political subdivision to elect to issue bonds the interest from which will be taxable, and the United States will pay an interest subsidy so as to reduce the interest payments made by the State or a local subdivision. This will be referred to as the "interest subsidy provision".

Ample testimony will be presented to show the fiscal impact on municipal financing and to support our feelings as set out above; that no need for a federal subsidy will be shown by those involved and objections come from all levels of government of the States and subdivisions as well as citizens (other than those attempting to justify their political, social and constitutional reform program); to show the wiseness in our present system; to show that the actual result of such a tax will be an increase in the tax of those with lower incomes; to show the legislation will complicate unduly the income tax provisions relating to bonds; to show the extent to which such legislation will be resisted in court causing additional continued market uncertainty and therefore higher costs to municipalities; that feasible projects will not be financeable thus increasing the demand for grants and aids and federal expenditures and be an impetus to further inflationary trends.

We feel the Federal Government is physically unable to fill the void. Consider the multi-agencies involved with grants and attempts to aid smaller communities in financing improvements for water, sewer and recreation. The lack of success of the loan program is indicative of the general lack of needs of governmental involvement in financing. Where costs exceed ability to repay, grant in aid programs have been useful to obtain desired results.

Public housing financed by municipal corporations has been successful because the United States Government is willing to guarantee payment of bonds and pay all deficiencies of rentals set low for income groups. This would not work where bonds are payable from taxes or from assessments on a local level. Tax legislation will take municipalities out of federal housing or raise financing costs. For the United States Government to have all States and local municipalities as a partner in this program independently financing, planning and executing is one of our Federal Government's major assets and this is one sane approach not to be tampered with.

We feel the Subsidy Provision is absolutely unnecessary and is as conducive to higher costs and uncertainty as is taxation of the bonds themselves. We do not agree that a compromise enactment of these provisions is possible. The confusion

created by conflicting interpretations and controls which would develop together with governmental promotion of their program would be costly, cause delay and increase costs.

Our Governor, before the Ways & Means Committee proposed a detailed study of the problems. In this we concur. We do not concur in any inference in his other testimony or any testimony before this committee, that a subsidy system for higher interest on bonds incurred where taxation immunity is waived by States would be useful in any way--but rather harmful as outlined above.

SUMMARY OF PRINCIPAL POINTS INCLUDED IN
STATEMENT ON H.R. 13270
BY PATRICK H. RENSCH, SPECIAL COUNSEL FOR THE MAYOR
& COUNCIL OF NORTH PLATTE, NEBRASKA; AND LANGFORD L.
JORGENSEN, ADMINISTRATIVE ASSISTANT TO THE MAYOR OF
NORTH PLATTE, NEBRASKA

All provisions of H.R. 13270 relating to taxation, direct or indirect, or under subsidy and tax waiver agreement are opposed. Results will be increased financing costs, loss of local governmental interest and economical operation; local taxes and the costs of utilities paid by most tax-payers will be increased; confusion caused by threat of taxation; lack of confidence due to taxation of outstanding bonds and anticipation of court litigation pose long-term uncertainties compounding the results of anticipated tax; and taxation of bonds is not tax reform but political, social and Constitutional reform. The subsidy provision is part of this reform, and unwise and costly.

We believe in the principal of the sovereign state as a partner with the Federal Government, not its tool, and the taxation of municipal bonds is the key to this independent action. We ask you to strike all references to tax and subsidy.