TAX REFORM ACT OF 1969

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIRST CONGRESS

FIRST SESSION

ON

H.R. 13270

TO REFORM THE INCOME TAX LAWS

PART 5 OF 7 PARTS

SEPTEMBER 26, 29, 30 AND OCTOBER 1 AND 2, 1969

GENERAL OUTLINE OF ORAL AND WRITTEN TESTIMONY IN PART 5:

- Corporations
- Farm losses
- General
- Interest
- Natural resources:
  - Hard minerals
  - Oil and gas
- Public utility depreciation
- Real estate depreciation
- Tax-exempt organizations (advertising income)

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TAX REFORM ACT OF 1969

FRIDAY, SEPTEMBER 26, 1969

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met pursuant to recess, at 9:30 a.m., in room 2221, New Senate Office Building, Senator Clinton P. Anderson, presiding.

Present: Senators Long (chairman), Anderson, Talmadge, McCarthy, Williams of Delaware, Bennett, Curtis, Miller, Fannin, and Hansen.

Senator ANDERSON. The hearing will be in order. I will ask Senator Bennett to introduce the first witness.

Senator BENNETT. Thank you.

The first witness this morning will be Mr. Wallace R. Woodbury representing the National Association of Real Estate Boards. Will you come to the table, Mr. Woodbury? Do you have a group of other people with you?

Mr. WOODBURY. Yes, sir.

Senator BENNETT. Mr. Chairman, we are having a regular procession of Utah witnesses. We had one yesterday, and I am very happy to welcome Mr. Woodbury this morning. He and his father before him have been among the leaders in the real estate field in Salt Lake City covering the whole range of brokerage, management appraisal, counseling, mortgage brokerage, and residential, commercial, and industrial development.

Mr. Woodbury also serves as vice president of the Association of Real Estate Boards, and is chairman of their Committee on Taxation of the Realtors' Washington Committee.

Mr. Woodbury, will you identify the gentlemen who are with you?

STATEMENT OF WALLACE R. WOODBURY, CHAIRMAN, SUBCOMMITTEE ON FEDERAL TAXATION, REALTORS' WASHINGTON COMMITTEE, NATIONAL ASSOCIATION OF REAL ESTATE BOARDS, ACCOMPANIED BY EDWIN KAHN, SPECIAL TAX COUNSEL, AND JACK WILLIAMSON, LEGISLATIVE COUNSEL

Mr. WOODBURY. Yes, thank you, Senator Bennett.

Mr. Chairman, and honorable members of the committee, the gentleman on my left is Mr. Edwin Kahn, our special tax counsel. The gentleman on my right is Mr. Jack Williamson, our staff legislative counsel.

Senator BENNETT. Mr. Woodbury, you may proceed with your statement. You may be interrupted during the statement but usually we wait until you finish.

Mr. WOODBURY. Thank you very much, Senator Bennett.

Mr. Chairman, and members of the committee, we appreciate this opportunity to testify on this matter because the problems in this bill affecting the real estate industry affect not only the real esate broker, the risk takers who participate in development, ownership and operation of real estate, the many people who depend upon the construction industry for their livelihood, but also the millions of private corporations and individuals who own or rent property.

The 1962 and 1964 amendments were weighted heavily against real estate. Although useful lives for depreciation were shortened for nonreal estate, they were not so treated for real estate.

Also section 1250 was enacted providing for recapture of accelerated depreciation on a graduated scale if the sale occurs during the first 10 years.

Department of Commerce reports show that the relative portion of the total fixed investment capital commanded by real estate dropped from 34.7 percent in 1961 to 24.6 percent in 1968, leaving only 70.9 percent of the 1961 share of investment capital.

Now, with our housing inventory depleted, and at a time when we are achieving less than 60 percent of our national housing goals, with high interest rates and construction costs to cope with, real estate investment is now facing the lethal ax of an unbalanced tax reform.

Admitting that some inequities exist in the tax laws, our industry has encouraged reform and made specific recommendations to the House in that regard, subject only to the equitable condition that the aggregate of supposed reforms be not so weighted as to further impair the competitive position of real estate in the total market for fixed investment capital.

We unequivocally assert that the bill before you if enacted would dramatically impair such competitive position, with disastrous results.

In the time allotted we shall refer to only a few of the 27 provisions of this bill noted by our counsel as adverse to real estate.

In order to impartially measure the impact of the proposed changes in depreciation and capital gains, we employed Dr. Soelberg and Dr. Stefaniak of the University of Wisconsin School of Business because of their considerable experience both in fields or real estate and computer analysis. They have developed a computer model to test the impact of such proposed changes on investor yield. From a combination of their experience and the market data available to them they selected typical investment characteristics as assumptions. They ran 45 test runs and drafted a report which will be delivered to each of you after today's hearing. It has also been submitted to the Treasury.

We respectfully ask permission, Mr. Chairman, to file this report as part of the record, because we believe it provides meaningful data, and it was not available until the last 24 hours in complete form.

Senator ANDERSON. Without objection that will be done.

(The data referred to was received by the Committee and made a part of the official files of the committee.)

Mr. WOODBURY. Thank you.

Table 4 of the report, and I know you don't have it before you, but to give you an idea of the impact on yield, table 4 of this report shows the yields before and after for new residential, new nonresidential and existing properties, and we can see the changes of yield to the investory by looking at that table. These are reflected as the internal rate of return which we believe to most fairly represent the measure of investors' total benefits. It is also a measure that is used with stocks and bonds and other investments.

Looking, for instance, at the 10-percent downpayment, 90-percent mortgage situation, which would be typical, for instance, on a residential deal, and assuming a mortgage interest rate of 8½ percent, the yields to investors in a new residential property—in the income tax brackets of 35 percent, 50 percent, and 58 percent—dropped 15.5 percent, 20.2 percent, and 27.1 percent respectively as a result of the proposed changes.

On new nonresidential, in those same tax brackets, yields dropped 24.2 percent, 33 percent, and 41.3 percent, and on existing property that is resold, the yields dropped 16.3 percent, 23.4 percent, and 32.5 percent, respectfully, for those tax brackets.

You should note that yields on new residential investments dropped, notwithstanding, the retaining of the 200-percent declining balance method and dropped substantially. Needless to say, compared to other investment yields in the marketplace today, real estate, which was already losing ground since 1961, would not be competive and would either grind to a stop or be greatly retarded for both new construction and resale transactions.

Significantly the small builder-developer owner is the most severely affected, while corporate and other large investors might be able to provide the equity capital for additional projects without resale. The small builder must from time to time resell to generate equity capital.

Moreover, low-cost housing might well be the first to be chopped off. An investor limited by FHA regulation to a 6-percent return from the property has relied on tax yield as a supplement to making the investments competitive. This proposed law not only reduces that yield, but if the developer falls under the limited tax preference rules, he might lose other personal deductions, not related to this property, under the proposed allocation of deductions.

Perhaps the most misunderstood result of these proposals relates to misprojections of Federal revenue to be derived from these changes. Some tax theorists have attacked depreciation deductions as unrealistic on the theory that inflation and other factors offset physical deterioration. They suggest that Uncle Sam should share in these inflationary benefits. They forget that although ad valorem taxes are subject to annual reassessment, the only substantial revenue sources to the Federal Government occurs upon sale.

The Treasury's projections of $1 billion additional corporate tax and $300 million additional individual tax are based on the erroneous assumption that the same number of starts and resales would take place under the new law, which is patently ridiculous when you consider the fantastic drops in yield on real estate investment. Care need be rather taken to avoid cutting off that revenue source altogether.

Rehabilitation must be encouraged by incentives, and we favor the special short-term write-off provisions of this bill.

However, it should be noted that they are utterly useless with a 100-percent recapture of those benefits.

Let us sensibly involve the private sector in solving our urban problems on a broad base.

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We urge you, therefore, to restore the 150-percent method for all resales.

No. 2, to limit recapture to a reasonable period and if the present 10 year period is deemed unreasonable we would suggest perhaps a period running to 13 years and 4 months which would include total recapture of excess depreciation until the sixth year.

No. 3, we strongly urge you to reject Treasury proposals that would deny the deductibility of costs actually incurred during the course of construction, but which aren't part of this bill at present.

No. 4, we urge you to reject the limited tax preference provision unless it is applied across a very broad base so as not to single out real estate. If the base is broad enough to encompass all sources of preferential income we would then favor such a provision.

Further, we believe you should provide for valid incentives for rehabilitation, and we ask that you reject proposals on interest limits and net losses because the ramifications are very severe in those areas. Thank you very much for the opportunity to be heard.

The CHAIRMAN. I would hope we could reserve questions until we have heard all the witnesses this morning. Then those who want to question could be interrogated, if that is all right with the committee members. In that case members who can't be here for the afternoon can hear all the witnesses. Is that all right?

Senator BENNETT. Mr. Chairman, I would just offer one slight amendment. Can we hear all the witnesses who are going to testify or are all the witnesses going to testify on real estate transactions this morning?

The CHAIRMAN. Essentially that, yes.

Senator BENNETT. Because there is no use in asking a man, reserving a question unrelated to the group.

The CHAIRMAN. That is all right.

Senator FANNIN. Mr. Chairman, do I understand there will be no questions?

The CHAIRMAN. I would hope we could hear all the witnesses first. Then anyone who wants to ask questions can ask them. If that is all right we will proceed that way because some Senators will not be able to be present at the afternoon session.

Senator MILLER. I think this generally is a good approach but I can understand how something significant could come up and if we could limit ourselves to one question on an understanding that this only occur on a rather occasional basis.

The CHAIRMAN. Fine.

Thank you very much.

Senator ANDERSON. Mr. Woodbury, it has been suggested that the "tax reforms" relating to housing are necessary to "slow down" the economy. Would that not justify the proposed reforms?

Mr. WOODBURY. Although the attempted goal of the tax laws is to slow down the economy, it is essentially and economically suicidal to use an essential commodity, such as housing which is already in critical short supply at a time when new family demands are rapidly increasing, as the vehicle to control monetary policy. It is essential that housing rather be encouraged, and other areas less critical be used for physical restraint.

Senator ANDERSON. Mr. Woodbury, if you oppose "limited tax preference," how would you get at the people mentioned in the Treasury report, who have large cash flow incomes, but pay little or no tax?

Mr. WOODBURY. The Treasury report in singling out 155 individuals with large "adjusted gross incomes" who paid no tax was not related to the areas covered by the limited tax preference rules. Real estate depreciation and capital gains have already been reflected in the tax return before determining gross income. Those mentioned by the Treasury received their shelters from interest payments and charitable contributions. We are, in fact, in favor of a minimum tax law. If the limited tax preference provisions were established over a broad base, we would favor them, but the rule is precipitating to a discriminatory tax merely upon real estate income. Even the farmer can be excluded by choosing an accrual method of accounting. We, therefore, oppose the form of limited tax preference as it is now precipitating.

Senator ANDERSON. Thank you.

Mr. WOODBURY. Thank you.

(Mr. Woodbury's prepared statement follows:)

STATEMENT OF WALLACE R. WOODBURY, CHAIRMAN, SUBCOMMITTEE ON TAXATION, REALTORS' WASHINGTON COMMITTEE AND A VICE-PRESIDENT OF THE NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

SUMMARY

Introduction

Several provisions of H.R. 13270 will have an intensely adverse effect on everyone connected with real estate, whether as property owner, investor, builder, broker, tenant, or just as resident or worker in an urban community.

NAREB position on tax reform

Endorses the concept of minimum tax provided that all sources of so-called tax preferences be included in order not to impair real estate's already precarious competitive role in the private investment market. The limit on tax preferences (LTP) in the bill does not meet this criterion. House-approved and Treasury-recommended exceptions would make real estate the principal if not sole target of LTP.

Douglas Commission on Urban Problems recommended that an income tax system should include special preferences to housing investment . . . warned that any "loophole-closing" . . . if applied only or more strenuously to this (real estate) than to other competitive investment fields, would probably curtail the flow of resources and managerial efforts into this area."

Critical condition of real estate industry

For 15 years construction has been accounting for a slowly declining proportion of gross national product. This has made the "problem of the cities" the nation's primary domestic concern. It is essential that the development of commercial structures, industrial and warehousing facilities, as well as housing, keep pace with population growth and the trend toward urbanization, and opportunity for replacement and renewal.

H.R. 13270 will have a depressing effect on real estate construction, improvement and maintenance. It will occur at a time when shortages are developing in residential and non-residential properties, and our national housing goal of 26 million units in 10 years is receding from view.

SUMMARY OF ARGUMENTS AND RECOMMENDATIONS

Depreciation

The 150% depreciation method now available for existing buildings should be restored. Limiting existing buildings to the straight-line method has already had a serious restricting effect on the resale market.

Present accelerated methods (200% double declining balance and sum-of-the-years digits) should be available to non-residential new construction. Elimination of such methods will result in reduced yields to investors. In a competitive financial market investors will seek out other high yield and less risky sources than real estate investment.

Should the Congress enact a provision to recapture a greater portion of depreciation taken in excess of straight-line as ordinary income, there is no logical basis for discouraging real estate investment and construction through denial of existing accelerated methods.

Recapture

The proposal in the bill to recapture as ordinary income all depreciation taken in excess of straight-line, without limitation as to time, is an extremely harsh measure which does not differentiate between a long-term investor and a short-term holder of real estate. The Committee might consider a provision that for the first five years all depreciation in excess of straight-line be recaptured as ordinary income, then reduce the percentage of gain taxed as ordinary income 1% per month. *Certainly an investor who has held property for more than thirteen years is entitled to full capital gains.*

The House-approved bill purports to retain an incentive for new residential construction and for rehabilitation of low and moderate income housing by allowing more rapid depreciation. Such incentive is almost completely neutralized by the harsh recapture provision in the bill.

Limit on tax preference

The LTP should be abandoned altogether unless all sources of so-called preferential income are included. The House has eliminated the oil industry; the Treasury wants to eliminate tax-exempt interest on local and state bonds and appreciated value of assets donated to charity. This leaves real estate and the so-called gentleman farmer as the only targets for LTP—an unnecessary and inequitable discrimination that should be repudiated by the Committee.

Limitation on deduction of investment interest

The Treasury Department has properly recommended that this provision be eliminated from the bill. The provision is discriminatory, unworkable, and would discourage holding unimproved land for future development.

Installment sales

As presently drafted the proposal on installment sales reporting would discourage the development of unimproved property because builders must await development and adequate outside financing before they can pay fully for the land and incur tax liability. The House bill greatly over-reaches the problem at which it is aimed and its retroactivity is unconscionable. The provision should be deleted until a provision can be formulated which would not interfere with legitimate and necessary methods of financing real estate transactions.

Hobby losses

Loose general language in this provision would deter the holdings of property in deteriorating neighborhoods because lack of current profit would create a presumption that the venture is not profit-motivated and all deductions would be disallowed. Abandoned buildings are proving a tremendously vexing problem to urban areas; this provision in the bill would aggravate this problem because it would have the effect of further increasing the cost of holding property in blighted areas.

Allocation of deductions

The Committee should recognize that interest, taxes, and casualty losses for rental real estate are business deductions and should not be subject to allocation; also, interest and taxes on unimproved real estate held for development should be considered business deductions and not subject to this allocation provision.

STATEMENT

Introduction

Mr. Chairman and members of the Committee—

I welcome this opportunity to testify on behalf of the National Association of Real Estate Boards in these hearings on H.R. 13270, the Tax Reform Act of 1969.

First, by way of background, I am a Realtor engaged in the business of real estate brokerage, management, development, appraising, and mortgage banking in Salt Lake City. I am a Vice-President of the National Association of Real Estate Boards and Chairman of the Subcommittee on Federal Taxation of its Realtors' Washington Committee. Our Association consists of more than 89,000 Realtors who are members of more than 1,500 boards of Realtors located in every state in the Union. Our members are engaged primarily in the business of brokerage, management, and appraising. However, the activities of our membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and industrial development.

Our association is familiar with the problem of the large number of individuals and corporations who take the risk of developing and operating real property. The problems of the real estate industry affect not only the risk takers who participate in development and operation of real estate, but also the hundreds of thousands of people who depend upon the construction industry for their livelihood, and the millions of individuals and corporations who rent or own real property. [1]

Several provisions of this bill will have an intensely adverse effect on everyone connected with the real estate industry, whether as property owner, investor, builder, broker, tenant, or just as resident or worker in an urban community. This is our first opportunity to comment on these provisions. The House Ways and Means Committee requested testimony on the possible modification in the treatment of real estate where accelerated methods of depreciation are used, and we testified on that.[2] The bill before this Committee is not limited to this provision, but it attacks the real estate industry in a variety of ways with a number of novel and complex provisions:

(1) Severe limitations on the availability of accelerated depreciation.

(2) A harsh and unfair rule for recapture of accelerated depreciation on disposition of the property:

(3) Application of the Limit of Tax Preferences (LTP) with particular emphasis on real estate deductions;

(4) Application of the allocation of deductions with particular emphasis on real estate deductions:

(5) Limitations on deductibility of investment interest; and

(6) A "hobby loss' rule designed for gentleman farmers which literally would apply to all real estate which fails to produce taxable income.

We believe it is desirable for this Committee to valuate the operation of these proposed adverse changes in the light of their actual impact on private property ownership and the real estate industry today.

However, before discussing the status of the industry, I believe it is desirable for the Committee to be aware of the position our Association took last winter on the question of tax reform. We also wish to call attention to the report of the Douglas Commission on Urban Problems with respect to our industry and the tax laws.

Position as to Tax Reform Taken by NAREB in March 1969

Probably the single most significant fact with respect to the consideration of tax reform was the disclosure by Acting Secretary of the Treasury Joseph Barr in January 1969 that for the year 1967 there were 21 individuals with adjusted gross incomes in excess of $1,000,000, and 154 individuals with adjusted gross incomes in excess of $200,000 who paid no federal income tax.

It should be noted that the principal causes of this result for these taxpayers were the deduction for charitable contributions (49 cases), personal interest (72 cases), and state and local income taxes (12 cases) (Treasury Tax Reform Proposals, April 22, 1969, page 67, table 5). These cases could not have resulted from accelerated depreciation of real estate and capital gains, since these items are taken into account before arriving at adjusted gross income.

Some of the provisions of the tax reform bill are directed toward preventing these results. Many other provisions appear to be not so directed.

In March 1969, prior to the hearings before the House Ways and Means Committee on tax reform, the Realtors' Washington Committee of the National Association of Real Estate Boards met to consider an official position to recommend to the Board of Directors of our Association on the subject of tax reform. Notwithstanding the fact that representatives of various industry groups were taking the position that no changes in the tax laws were necessary, the Realtors' Washington Committee responsibly recognized that there were some tax inequities and recommended a positive approach to prevent these inequities. Specif-

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[1] $7.3 billion of multifamily residential housing was put in place in 1968; commercial construction in 1968 amounted to $8.3 billion. Real estate construction provides employment for more than 3.2 million people.

[2] The sole real estate issue proposed for testimony by the Ways and Means Committee read: "As to possible modification in the tax treatment of real estate where accelerated methods of depreciation are used."

ically, the following resolution was recommended for adoption by the National Association's Board of Directors:[3]

"The National Association of Real Estate Boards urges that no changes be made in the tax laws which will impair the competitive position of real estate in the investment market.

"To assure that all persons assume a share of the burden of taxation, we recommend that the Internal Revenue Code be amended to provide for a minimum income tax, which would be applicable if it exceeds tax liability under the regular rates. Such a minimum tax should be based on an expended income base, which must include the following without exception: (1) the excluded one-half of long-term capital gains, (2) tax-exempt state and local bond interest, (3) percentage depletion in excess of cost depletion of property, (4) excess of fair market value over basis of property contributed to charity, (5) intangible drilling expenses, and (6) excess of accelerated depreciation over straight-line depreciation (with appropriate adjustments to basis). Such expanded income base should be subject to a graduated rate not in excess of one-fourth of the regular ordinary rates.

"We vigorously oppose the imposition of a capital gains tax on the appreciated value of capital assets at the time of death of an owner; but we support a change in the tax law so that heirs and legatees succeed to the cost basis of the decedent with an appropriate adjustment for inheritance or death taxes paid."

NAREB continues to adhere to this position. We favor the approach now known as Limit on Tax Preferences (LTP), which has the same purpose as the minimum income tax, which would get at these inequities *provided that the approach is applied across the board to all areas considered productive of potential tax inequity and not directed primarily toward real estate.* We would similarly favor alternative approaches directed at accomplishing the same goal, particularly if simpler than the intricate, complex provisions of the House bill.

We have serious objections to the bill as passed by the House and to Treasury proposals made to this Committee, not because we object to changes to prevent tax inequity but because under the proposals essentially only real estate (and so-called gentleman farmers) would feel the hot breath of LTP. As passed by the House, five items would be included in LTP:

(1) tax exempt interest;

(2) certain farm losses;

(3) the excess of the value of property contributed to charity over adjusted basis;

(4) the excess of accelerated depreciation of real property over straight-line depreciation;

(5) the 50% long-term capital gains deduction.

Specifically omitted were percentage depletion and intangible drilling expenses.

Further, Treasury now proposes to omit from LTP tax-exempt interest and the excess value of appreciated property contributed to charity. Treasury proposes to add percentage depletion and intangible drilling expenses plus two real estate items: (a) the excess of losses during the construction period over income and (b) the excess of rapid amortization of rehabilitation expense on low and moderate income property over straight-line depreciation which deduction was created by Section 521 of the bill itself.

If the Treasury proposals are adopted and the House view prevails on the oil industry, the only areas reached by LTP provisions would be real estate (three separate provisions plus the long-term capital gains rule) and the so-called gentleman farmer.

Report of the National Commission on Urban Problems (Douglas Commission) As to Real Estate and the Tax Laws

Moreover, the provisions of H.R. 13270 are also inconsistent with the Report of the National Commission on Urban Problems. In Chapter 7 at page 10 the Commission stated:

". . . our special concern here is with the effect of present arrangements upon incentives for investment in housing, and it seems clear (1) That *existing tax provisions* have been 'institutionalized' into a complex set of economic relation-

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[3] Approved March 26, 1969, by NAREB Executive Committee. Subsequently approved by the Board of Directors May 13, 1969, with an amendment to add the following to the end of the second paragraph: "We recommend a 5-year carryover of any disallowed deduction as an offset to future income from the six items recited above".

ships that *involve* a large volume of investment as well as the provision of *rental housing for about one-third of all American families;* and (2) That *any 'loophole-closing'* efforts, if *applied only or more strenuously to this than to other competitive investment fields, would probably curtail the flow of resources and managerial efforts into this area. . . .*" (emphasis supplied)

The provisions of LTP which apply "loophole-closing" more strenuously to real estate than to other competitive investment fields will do exactly what the Douglas Commission said it would do, that is, curtail the flow of resources and managerial efforts into this area—at the same time that this area needs greater efforts rather than less.

The Douglas Commission (page 11 of the same chapter) recognizes that "the Nation has an obvious stake in adequate investment in commercial as well as residential plant." It goes on to state that because of the particular public and social concern with housing, the question arises whether the income tax system should include some special preference to housing investment, and this question is considered in the final section of the chapter where the Commission makes its three recommendations.

The first of these recommendations is that the Treasury Department make an intensive analysis and submit explicit findings and recommendations concerning tax law changes best suited to provide materially more favorable investment in new residential construction (including major rehabilitation) than for other forms of real estate investment. This recommendation does not mean that the income tax laws should be changed in the manner proposed by H.R. 13270, so as to impose severe burdens on all real estate investments with slightly lesser burdens on housing. Such provisions seriously impair the competitive position of real estate as an investment. Rather, the Commission appears to contemplate only those changes in the tax law which would give new preferences to investments in residential construction.

Such new preferences are more specifically identified in the other recommendations of the Douglas Commission—that preferential depreciation allowances or investment credits be provided for investment in governmentally-subsidized low and moderate income housing and that there be especially generous tax treatment of investor-owners' expenditures for maintenance and rehabilitation of older rental residential structures (for example, the rapid amortization of rehabilitation provided by Section 521 of the House bill).

Critical Condition of the Real Estate Industry

We believe that at this point it is desirable for the Committee to consider the present state of the real estate industry.

Necessity for commercial and industrial as well as residential real estate

First, as we discuss in more detail below, the proposed bill attacks all aspects of the real estate industry but places special additional burden on commercial and industrial real estate as compared to residential real estate. This is inconsistent with the needs of the country.

We are not a nation of dormitories. Although housing is in critically short supply, the development of livable communities entails more than the erection of suitable living quarters. Unless a concept of the "total community" remains viable, through equal treatment and encouragement of residential, commercial, and industrial development, we shall find ourselves unable to provide effective housing relief. Those who need housing the most will be unable or unwilling to remove themselves to a sterile community which is inaccessible to employment, shopping, and services.

Today, about 75% of our population live in an urban environment. If current projections materialize, 85% of the population will be living in and around cities by the year 2000. It is essential that the development of commercial structures, industrial and warehousing facilities, as well as housing, keep pace with population growth and the trend in urbanization, and provide opportunity for replacement and renewal.

By common consent the problems that we lump together as the "problems of the cities" are the nation's primary domestic concern. Solutions to these problems are being sought under programs that we know as urban renewal, model cities, and other actions to rebuild vitality into the hearts of our cities. None of these programs can succeed if the end product must be confined to providing new residential dormitory space around the fringes of these areas. An era of true urban renewal and rebirth of our great city centers must rest on a balanced program of providing facilities for every type of urban land use, including needed commercial and industrial development and upgrading of existing facilities to make the result a viable community.

Impact on new construction

Secondly, these provisions of H.R. 13270 will adversely affect construction of buildings, an essential element for the replacement and renewal of the nation's physical plant in general, and the urban community in particular. Construction by the private sector of the economy has not been keeping pace with the current boom, and it will suffer even more under the proposed provisions.

Over the past 15 years construction has been accounting for a slowly declining proportion of gross national product. Construction's share in current dollars dropped from almost 12% in 1955 to 10% in 1967 and held at that level last year. More significantly, while public construction more than kept pace with the rise in gross national product, private construction failed to enjoy a similar increase in rate.

Despite accelerated depreciation as an investment attraction, the rate of growth *fell behind other sectors of the economy*, whether viewed as a share of gross national product or as a share of gross private domestic investment.

Shortage of supply

Third, the depressing effect of these new provisions of H.R. 13270 on real estate construction, improvement, and maintenance is occurring at a time when there is developing a real shortage of supply in both residential and nonresidential properties.

Occupancy rates in habitable residential properties are higher than at any time since the period immediately following World War II. Rates are impressively high also in commercial and industrial structures.

Results of the Census Bureau's sample survey of residential vacancies show a decline in the rental vacancy rate from 7.2% in the first quarter of 1960 to 5% in the same quarter of this year. Our routine NAREB market report indicates a similar level of scarcity at all price levels.

Similar occupancy trends have been experienced in the nonresidential component of the market. Our Spring 1969 report indicated that the demand for commercial and industrial space more than kept pace with additions to the inventory over the past four or five years. The market readily absorbed the volume of office space added by both new construction and renovation, with the result that, last spring, vacancy rates in prime location center city buildings were 2% or less in nearly one-half (47%) of the nation and 3%–5% in 31%. In office buildings located in the suburbs a vacancy rate of 2% or less was reported for 45% of the nation and 3%–5% for 42%. At the same time, the demand for industrial space is accelerating and vacancies in both manufacturing and warehousing structures and single-story design were lower than the previous year in more than three-fourths of the country. The Building Owners and Managers Association's survey of office space occupancy showed continuation of the upward trend this year. An increase of 2.7% in occupancy over May 1968 was reported.

Those who desire to occupy residential and nonresidential property will be the sufferers as a result of the effect of the new tax provisions in reducing the supply of new real estate or usable improvements to real estate.

Furthermore, the Ways and Means Committee made at least one significant factual error in its decision. The House Report (page 166) states: "The present [depreciation] treatment creates a tax environment favorable to frequent turnover which tends to discourage long-range 'stewardship' and adequate maintenance." In our judgment, there is no factual basis for this statement. The truth is exactly the reverse. It is precisely the owner who is going to sell who must maintain his property in order to make it as attractive as possible to prospective purchasers; if he does not, he will either be unable to sell or he will have to take a substantial discount because of poor maintenance. It is precisely the owner who is going to hold for a long time (either by choice or because he is "locked in") who can skimp on maintenance, doing only enough to keep tenants minimally satisfied.

Finally, it should be noted in the revenue considerations applicable to these provisions that the one certainty of the government obtaining revenue is the case where the taxpayer will sell his property at a gain. *Discouraging such sales is bound to decrease the federal revenue.* No revenue is obtained because of increases in value in the absence of a sale. It is true that decreasing the depreciation deduction may improve revenue collections, but this is true only to the extent the taxpayer is in fact operating his property at a profit, so that the depreciation deduction offsets what would otherwise be taxable income. The taxpayer must reduce his tax basis by allowable depreciation regardless of whether or not it produces a tax benefit. Accordingly, this depreciation deduction (whether or not it produces a tax benefit) does tend to result in a potential gain on the sale of the property if the property does not decline in value as rapidly as the applicable depreciation. The tax on this gain (and in the usual case on the greater gain which results from appreciation in value of land) is not obtained by the government except in the event of sale.

Thus, we have two situations which are *not* taken into account in this bill. One is the fact that discouraging sales may result in property not being properly maintained. Secondly, it will tend to decrease revenue because of the postponement of collection of the tax now collected when sales are made at a gain.

Importance of real estate industry to the economy

The enormous potential impact of a cutback in real estate construction on the economy can be seen from the following figures: [4]

	Private construction	Private nonfarm housing starts	Contract construction employment
	Billions	Thousands	Millions
1963	$43.9	1,581.7	3.0
1964	45.8	1,502.3	3.1
1965	50.3	1,450.6	3.2
1966	51.1	1,141.5	3.3
1967	50.6	1,268.4	3.2
1968	57.0	1,483.6	3.3

The Economic Impact of H.R. 13270

The newspapers are full of stories that the main effect of the tight money policies of the Federal Reserve System, inaugurated in the beginning of this year, has been felt by real estate. Mortgage money is less and less available and at higher and higher cost. The financial squeeze has caused a real estate recession which has already caused untold hardship to tenants, to home owners, to construction workers and suppliers. The ripple effect from them to the rest of the economy is substantial. Tight money was the first punch against real estate in 1969.

If the tax reform bill is enacted as approved by the House, and even more so if the additional Treasury proposals recommended at the eleventh hour are enacted, these proposals will be the second punch. Taken together this one-two punch will cause a serious real estate depression with grave consequences for the entire economy.

Analysis of Adverse Provisions of H.R. 13270

We shall now address ourselves to some of the major provisions of the pending bill which will cause the adverse effect on real estate which we have described above.

Depreciation of real estate

Congress thoroughly considered the application of accelerated depreciation to real estate in connection with the Revenue Act of 1964. As a result of its consideration, the Congress decided to leave unchanged the provisions for accelerated depreciation of real estate. It did enact a recapture provision now incorporated in Section 1250 of the Internal Revenue Code. Under this provision, gain on the sale of a building, to the extent of depreciation taken, is taxable as ordinary income in full if the property is sold in the first year, and to the extent of all or a portion of the excess of the depreciation taken over straight-line depreciation if the building is sold after the first year and before the end of the tenth year. This excess is treated as ordinary income under a sliding scale dependent on the

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[4] *Source:* Census Bureau, Department of Commerce; Bureau of Labor Statistics, Department of Labor; Department of Research, NAREB.

period the property is held, starting at 100% for the first eight months after the first year, and decreasing 1% a month from the 20th month until the end of the tenth year.

This is the existing law. It provides an adequate solution of the problems considered by the Committee. The 1964 law recognized that the problems arise only when there is a too rapid turnover of the property. Depreciation does in fact take place; buildings are in fact used up and are subject to obsolescence. After property has been held a substantial period of time, such as the period recognized in Section 1250, its sale at a gain does not represent any error in the computation of depreciation, but instead represents an appreciation in value of the remaining property which is the result of the same economic factors that cause appreciation in value of other investments (often appreciation in value of non-depreciable land).[5] Usually these factors are either inflation, a good income-producing record, or scarcity. This appreciation in value arises not from the property used up with the passage of time, but the remaining property. This appreciation in value is as much a capital gain as the appreciation in value of vacant land held for a number of years, or the appreciation in value of stock listed on the New York Stock Exchange. It might be noted that many listed stocks represent interests in corporations which take substantial deductions each year for depreciation, depletion, or both, and there is no recapture provision applicable to such stock.

An additional reason why accelerated depreciation is proper is because the Treasury requires real estate to use antiquated, unrealistically long useful lives which have not been revised for 27 years.[6] The combination of accelerated depreciation and overly long useful lives produces a barely adequate, not an excessive, deduction.

We might further note that the law enacted in 1964 has been in effect for only a little more than five years. There has been no new information produced before this Congress to indicate that any change in the law is necessary. On the other hand, we feel that the changes now incorporated in this bill would be disastrous for the real estate industry, as well as for millions of people affected by it.

First, this bill would change the existing laws relating to the depreciation deductions allowable for real estate. Presently, all new real estate construction (residential, commercial, and industrial) is eligible for the double declining balance or sum-of-the-years digits method of depreciation. All used buildings are presently eligible for the 150% declining balance depreciation method.

The bill would continue double declining balance and sum-of-the-years digits methods of depreciation *only for new residential rental housing.* Other new construction would be limited to 150% declining balance depreciation. *All* used property (residential, commercial, and industrial) would be limited to straight-line depreciation.

Furthermore, the bill would change the recapture provisions of existing law so as to eliminate the provision under which recapture decreases over a 10-year period. Instead, it would treat as ordinary income all of the gain on the sale of a building—whether residential, commercial, or industrial, and whether new or used—to the extent of the excess of accelerated depreciation taken after July 24, 1969 over straight-line depreciation.

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[5] It was for this reason that the Ways and Means Committee in 1962 decided not to act on a Treasury recommendation for full recapture of real estate depreciation. ". . . Committee decided not to apply this treatment to buildings or structural components of buildings at this time because testimony before the Committee indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period . . ." H. Rept. 1447, 87th Cong., 2nd Sess. (1962), p. 67.

[6] The Treasury in 1962 provided guidelines as to the useful life of property. For property other than buildings, these were far more liberal than the previous administrative rules (which were last revised in 1942) and represented a realistic acceptance of the increasing impact of technological obsolescence. This obsolescence is also true of buildings. The Treasury guidelines in 1962 recognized obsolescence for farm buildings by reducing the prescribed useful life of farm buildings from 50 years to 25 years. *However, in the case of all other buildings it either retained or increased the previously prescribed useful life,* requiring the use of periods that run from 40 to 60 years, and also eliminated the advantages of the building component method for shorter life portions of the building. The past Administration's Treasury Department officials have admitted that this was not an adverse factual determination by the Department but merely its reaction to Congress not adopting its 1961 recommendation as to real estate. "Since no action was taken by the Congress to provide recapture of excess depreciation on real estate, the administrative revision of depreciation guidelines in 1962 was confined, in effect, to personal property. While guideline lives were provided for buildings, they were essentially the same as those in Bulletin F with the exception of farm buildings."—Tax Reform Studies and Proposals, U.S. Treasury Department (February 5, 1969), p. 447.

The bill does have one provision that provides a new incentive for rehabilitation if made to older residential property with low and moderate income tenants where unit expenditures for rehabilitation are between $3,000 and $15,000. Such rehabilitation costs would be written off on the straight-line method over a five-year life. However, the Treasury has requested this Committee to neutralize almost all of the benefits of this provision by providing that such deductions for renovation be treated as excess depreciation to be recaptured as ordinary income when the property is sold.

We cannot be too emphatic in our assessment of the adverse effect of the provisions limiting depreciation and increasing recapture. The depreciation deduction is directly related to the effective yield of an equity investment in real estate. In turn, the effective yield is an important factor in determining the value of the real estate investment. Hence, the reduction of the depreciation allowance results in a reduced yield; and the reduction in yield results in a reduced value. New construction is at a cost level which does not justify its being undertaken for the type of yield that would be available if this bill were enacted. The immediate effect of this bill will be that investors, who will seek the same yield they are presently receiving for the type of risk they are taking, will no longer invest in new construction. They will seek other sources of investment which are available to them, many of which have been considered in connection with this bill and left undisturbed.

We have already noted above the serious adverse effect on the nation from a drying up of new construction and a slowing down of the real estate industry. We are convinced that the House-passed bill contains the seeds of erosion of the privately financed real estate industry. We believe that this Committee must come to grips with the needs of the country for continuation of a healthy urban environment by rejecting the House approach.

Furthermore, the one area of buildings not subject to cutback in accelerated depreciation—that is, residential construction—is in fact penalized almost as much as other types of construction because of the recapture rules. Double declining balance depreciation will not be the needed adequate incentive for residential construction if the benefits given with one hand are taken away with the other hand by the harsh recapture rule of the House bill. Indeed, the President's Committee on Urban Housing (the Kaiser Committee) concluded that recapture under *existing law* had an adverse effect on investment in low and moderate income housing and recommended deletion of the present recapture rule for low and moderate income housing. ("A Decent Home"—Report of the President's Committee on Urban Housing, pp. 83–85) Similarly, the advantage purportedly given through a five-year useful life for rehabilitation costs would be largely removed if the same recapture provisions are applicable to these expenses.

The total recapture of the excess of accelerated depreciation over straight-line depreciation will virtually freeze or "lock in" any new investments which are made in real estate, and quickly stagnate the flow of capital into the industry, at the same time cutting down the flow of revenues to the Treasury. Obtaining equity financing is becoming very difficult if not prohibitive. The equity invested in real estate is a non-liquid asset. It is not traded on an established exchange or in an established market. It may or may not be readily saleable. This significantly increases the risk as compared to other investment opportunities, and demands a commensurately higher projected yield on the investment. The recapture provisions of the bill will significantly reduce the yield in the event of sale and greatly increase the cash payment requirements, while the allowance of only straight-line depreciation to a potential buyer will drastically reduce the already inadequate market for used buildings. The combined effect of these provisions will be, initially, a sharp acceleration of the present drop in real estate construction and development (because the return is inadequate). This must ultimately be followed by sharply increased rents to restore a competitive return to the investor before a belated increase in construction. This is highly inappropriate at a time when construction of housing units is less than 60% of the national goal. Many hundreds of thousands of persons will live in inadequate housing during the adjustment period.

It is our firm belief that existing methods of depreciation of real estate must be continued in order to maintain and increase the flow of equity capital into the real estate industry, consistent with the national housing goals and the maintenance of a viable real estate industry.

However, our Association recognizes that some changes may be made in the Section 1250 recapture period witout producing an excessively drastic effect on real estate. The present Section 1250 provides for total recapture of the excess of accelerated depreciation over straight-line depreciation during the period from the 12 through the 20th month, declining 1% per month therafter, so that at the end of ten years there is no recapture. If the Committee deems it necessary, the period of total recapture of such excess could be extended for four years, from the 12th through the 60th month, thereafter declining 1% per month. We believe that any capital gains thereafter resulting would surely be a consequence of capital appreciation and not unrealistic depreciation deductions. The market adjustment which such a change would necessitate, though adverse to real estate, might, we think, be within acceptable limits.

This change could be made very simply by changing the number "20" in Section 1250(a)(2) to "60". This change would eliminate eight pages of complex provisions in Section 521 of the bill, leaving only those provisions which grant a five-year write-off for certain rehabilitation costs.

Limit on tax preferences

The limit on tax preferences (LTP) provision has been publicized as the "minimum income tax" which sets a 50% limitation on the use of certain "tax preferences." The President has hailed the original proposal as a "major step toward assuring that all Americans bear their fair share of the federal tax burden." (Message from the President, April 21, 1969) However, the present posture of LTP is that it means "Let Them Pay"—and "them", we regret, are primarily investors in real estate.

We have supported, and we continue to support, a minimum tax proposal which would apply equally to all forms of income, and would maintain the equilibrium among investment opportunities.

As originally recommended by the Administration, the preferences included in LTP were:

(a) Percentage depletion on minerals and intangible drilling and exploration expenses in excess of normal deductions under regular accounting rules;

(b) The excess of accelerated depreciation over straight-line depreciation on buildings;

(c) Farm losses arising from unrealistic accounting methods;

(d) The excess of market value over basis of property contributed to charity.

The LTP proposal which is contained in HR 13270 added tax-exempt interest on state and local bonds to the items of tax preference recommended by the Treasury, and deleted percentage depletion and intangible drilling and exploration expenses.[7] The Treasury Department, in its statement of September 4, 1969, has again insisted that tax-exempt interest be excluded as a preference item, and the Department has changed its mind regarding the preference status of gifts of appreciated property to charity by urging its deletion from the list of tax preferences. Furthermore, the Treasury has recommended the *addition* of two more *real estate items* to the list of tax preferences: interest, taxes, and rents paid on real property during the period of construction of improvements thereon, and the rapid amortization of rehabilitation expenditures for low cost housing.[8]

Thus it appears highly possible that all that will be left of the widely touted minimum tax proposal is a higher tax on real estate investors (and some so-called gentlemen farmers), while buyers of tax-exempt bonds, owners of oil properties, and donors of appreciated property to charity will continue to have substantial opportunity to escape income tax. The result of this situation would inevitably be an outflow of equity investments in real estate toward these other opportunities for investment where current yields and market prices will remain stable. This is not tax reform but tax discrimination against real estate.

This is an intolerable situation for the real estate industry. The current market for various investment opportunities has been developed over the years so that investment yields are balanced in the context of relative risk, liquidity, management problems, and other factors which enter into one's judgment in choosing among available investment opportunities. In addition to upsetting the established investment yields from real estate through the drastic cutback

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[7] The bill also includes as a tax preference the excluded one-half of longterm capital gains, but it has been acknowledged that this is virtually meaningless because it would rarely affect the tax liability of a taxpayer.

[8] In addition, the Treasury has recommended that tax preferences should include accelerated depreciation in excess of straight-line depreciation on certain leased personal property, and percentage depletion and intangible drilling costs in certain cases.

in depreciation allowances and provisions for recapture contained in the bill, the present status of the LTP proposal singles out real estate as the almost exclusive object of LTP.

Further, the mechanics of LTP are such that it is quite impractical to attempt to compute its effect on a projected investment yield. LTP only affects tax liability when the items of "tax preference" exceed other income. Therefore, a taxpayer must (1) project his other income for each year of his projected investment in real estate—usually an impossible feat, (2) project the amount of his "tax preferences" for each such year—also usually impossible, and (3) compute the effect on his tax liability for each such year. Aside from the effect on the market price of real estate, it seems obvious that it would be simpler to choose a form of investment which is not subject to LTP rather than make these complicated and estimated computations in order to determine the merits and desirable terms of a real estate investment.

We, therefore, believe it is inappropriate, and misleading to the public, to impose a "minimum tax—on investment in real estate," and we believe that enactment of the LTP in such form would result in an unprecedented unheaval in the real estate industry. If there is to be a minimum tax, it should be a true minimum tax, which treats all investments alike. It would also be desirable if such an approach were mechanically much simpler than the complex LTP proposal.

Limitation on deduction of interest

Section 221 of the bill would impose an annual limitation on the amount of the allowable deduction for interest expenses paid by non-corporate taxpayers on funds borrowed to purchase or carry property held for investment. The maximum interest deduction each year would be $25,000 plus a taxpayer's net investment income and his net long-term capital gains.

The apparent purpose of the limitation on the interest deduction is to provide a "matching" of interest expense deductions with the income from the investment in respect of which funds were borrowed giving rise to the interest expense. It is assumed that a taxpayer would thereby be precluded from offsetting other income with interest expenses for an investment which is not yet producing income. The approach adopted in the bill is in lieu of an actual tracing of an interest expense to a particular investment, which would obviously be administratively unworkable.

However, the House-passed provisions do not work, and the Treasury Department has recommended their deletion.

This provision discriminates between a taxpayer who has current income-producing investment and a taxpayer who incurs an interest expense but has no current investment income. In the former case, the taxpayer may deduct his interest expense to the extent of his investment income even though the income-producing investment is unrelated to the interest expense, while the deduction may be denied to the taxpayer who is making his initial investment even though he has other non-investment income. Even worse, the carryover provisions of the bill do not allow the interest expense to be offset against the income from the investment at such time as the taxpayer receives it.[9]

If a taxpayer buys unimproved real estate and an interest deduction (for the mortgage loan incurred to carry it) is disallowed under the bill, he will not be able subsequently to deduct the interest from future income from any improvements he puts on the property (unless it is under a net lease), because the rents are considered business income against which the "investment interest" may not be a deduction. Whether or not the deduction will be later available will turn on whether or not the taxpayer net leases the property in the future. This startling

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[9] Some of the anomalies of the provision are: (1) The bill provides that the disallowed interest deduction may be carried over from one year to the next only to the extent a taxpayer has taxable income (which cannot be offset by the interest deduction) for the year of disallowance. If a $100,000 interest deduction is disallowed in 1970 when a taxpayer has $80,000 of taxable income, only $80,000 may be carried over to 1971; and if the taxpayer has only $20,000 of earned taxable income in 1971, only $20,000 of the original $100,000 originally disallowed interest would seem to be available as a carryover to 1972. (2) Also, it appears that even though an interest deduction has been disallowed in one year, the carryover may be disallowed in a subsequent year under the allocation of deductions rules of the bill. (3) Furthermore, the bill discriminates against taxpayers who have investments in two or more partnerships as opposed to a single partnership because the disallowance provisions apply at the partnership level first and then a second time at the partner's level. Therefore, the interest deduction of a taxpayer from one partnership may be prevented from offsetting his investment income from another partnership.

result is obviously unfair. Also, the taxpayer has the unanswered question of whether there is proportioning if the taxpayer builds a shopping center and some stores are under a net lease and others are not, such that all of the income is reportable but only a portion of the actually paid expenses would be deductible.

Installment sales

Section 412 of H.R. 13270 would amend the provisions of the Code relating to the installment method of reporting income from the sale of real property by providing a definition of an installment transaction which precludes from installment treatment those transactions in which the payments are not spread out in a prescribed manner over the installment period.

Although the primary purpose of this provision is to preclude deferral of income in a corporate "reorganization" transaction where the acquiring corporation gets a stepped-up basis for the acquired property, the definition is drafted so that it inappropriately affects the legitimate purchase money financing of many real estate transactions. For example, it is common in real estate transactions for sales to be made with relatively small payments to the seller for a substantial period, such as during the development of unimproved property, thereby allowing the buyer to use his resources for the development until adequate outside financing can be arranged. The provisions of the House bill would preclude this type of financing arrangement by imposing an immediate income tax liability upon the seller in such cases even though he has not received the proceeds of the sale to which the tax liability is attributable.

We submit that it is *not* an abuse of the installment method to allow this type of financing, and that the remedy contained in the House bill greatly overreaches the problem at which it is aimed. We urge the Committee to examine this matter and to formulate a provision which will not interfere with the legitimate and necessary methods of financing real estate transactions.

Hobby losses

Section 213 of H.R. 13270 would provide a new "hobby loss" provision which would deny a taxpayer the deduction for losses from a business activity where the activity was not operated with a reasonable expectation of realizing a profit from it. In addition, where an activity has been carried on at a loss in excess of $25,000 for three out of five consecutive years, it would be deemed—unless shown to the contrary by the taxpayer—that the activity is carried on without a reasonable expectation of realizing a profit.

Although included in the provisions dealing with farm losses, the provisions would literally apply to real estate.

The purpose of this provision is to preclude the utilization of losses by taxpayers to offset their other income where the losses are not incurred in a *bona fide* business activity.

It is submitted, however, that the test provided for determining the validity of a "business" activity fails to take into consideration an increasingly common business situation where there is *no* realistic expectation of realizing a profit but with respect to which a deduction should nevertheless be allowed: the case of a business property which has so declined in value that there is no reasonable expectation of selling it at a profit, and the taxpayer is holding it for sale at a loss or is waiting for some improvement in the market which will reduce his loss.[10]

One effect of the "hobby loss" provision would be to accentuate urban blight by destroying the market for many properties in difficult geographic areas. There are 12,000 to 15,000 abandoned buildings in New York City alone, presumably because the cost of demolition exceeds residual value. Many more abandonments would follow enactment of the hobby loss provision since it would have the effect of further increasing the cost of holding property in blighted areas.

Furthermore, the presumption that there is no reasonable expectation of realizing a profit from an activity when there are losses in three out of five consecutive years poses an unfair burden upon the legitimate real estate developer of unimproved property, where rezoning, development, and "rent-up" costs may produce losses for an extended period. Although this presumption may be

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[10] The Treasury proposal of September 4, 1969, that "profit" be defined to include any reasonably anticipated long-term increase in the value of property does not seem adequate to cover those cases where there is no existing market for the property and where the property may even be expected to decline in value during the period when a buyer is being sought. It would tend to create "panic" sales.

rebutted, it is an inviting sword to be used by the government in highly inappropriate cases—"You have losses and are therefore deemed not to have a reasonable expectation of realizing a profit." The Commissioner of Internal Revenue already has a general presumption of correctness in his favor when he asserts a tax liability. The addition of a new statutory presumption in this fashion would be an invitation for Revenue agents to conclude that hard, factual analysis of each situation is unnecessary: the presumption gives the answer.

It is therefore submitted that if there is to be a test relating to expectation of profit, this added presumption is unnecessary and likely to cause undue controversy because it implies the rejection of factual analysis.

Allocation of deductions

This provision is directed at personal deductions. We believe it desirable that the Committee recognize that interest, taxes, and casualty losses for rental real estate are business deductions not subject to this section, and that interest and taxes on unimproved real estate held for development as rental property are also business deductions not subject to this section.

The CHAIRMAN. The next witness will be Mr. Louis R. Barba, first vice president of the National Association of Home Builders.

STATEMENT OF LOUIS R. BARBA, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS; ACCOMPANIED BY HERBERT COLTON, GENERAL COUNSEL; AND JOSEPH McGRATH, STAFF VICE PRESIDENT AND LEGISLATIVE COUNSEL

Mr. BARBA. Mr. Chairman, and members of the Committee, my name is Louis Barba, I am the First Vice President, National Association of Home Builders. I have with me our General Counsel, Mr. Herbert Colton, to my left, and to my right is Joseph McGrath, our Staff Vice President and Legislative Counsel.

The National Association of Home Builders consists of approximately 51,000 members in 473 affiliated State and local associations. Our members build over 75 percent of the residential construction in this country, including both single family housing and apartments. They thus perform a vital economic and social function, a function which the Congress has recognized and encouraged for the past 35 years.

Attached as an appendix is a more extensive statement of our views on H.R. 13270. Since our time is limted, I can sum up these views in a sentence or two. H.R. 13270 would completely cancel that 35-year effort insofar as rental housing is concerned. It would drastically curtail the flow of investment capital at the very time when our industry already faces critical credit problems.

While the bill would retain 200 percent accelerated depreciation on new rental housing, it would almost completely negate this (1) by the provisions which greatly increase recapture; (2) by restrictions on depreciation which may be taken by a second owner; and (3) by inclusion of accelerated depreciation in the limit on tax preferences and the related allocation of deduction.

The bill would practically destroy the resale market for depreciable real estate. Owners of "locked in" rental housing could not afford to sell their property at any point prior to the end of its useful life, which could be 40 years or more. This is because under the bill any sale prior thereto would result in recapture as ordinary income of the entire amount of excess accelerated depreciation over straight-line.

Facing such a "lock in" developers would not dare build; investors would not find rental housing attractive; and those few who did invest would not be able to revolve their funds for reinvestment in new construction.

We oppose Section 421(b) which removes the present concept of a cumulative percentage reduction in depreciation recapture.

We also object to and recommend elimination of the provisions in the bill which would limit "second owner" depreciation on rental housing to straight-line. We recommend the existing 150 percent depreciation for second owners of residential rental housing be retained.

The total impact of the proposed increased depreciation recapture plus the restriction to straight-line depreciation on used rental housing, and the interaction of these two proposals, will assuredly have a disastrous effect on the housing industry. Owners of rental housing will not sell—because of the substantial depreciation recapture—and potential purchasers will not be interested in buying—because of the limitations to straight-line depreciation. Investment funds will be diverted from new rental housing—always and inherently a highly dubious investment on a pure economic basis—into other more attractive forms of investment.

The homebuilding industry supports the concept of a minimum income tax. We believe everyone in the United States should pay a fair share of taxes.

However, we think the proposed limit on tax preferences and allocation of deduction provisions would further significantly diminish the stimulation of accelerated depreciation for residential rental housing, in that they include the excess of accelerated depreciation over straight-line as a "tax preference." The effect of such treatment under the LTP proposal would be to generate additional income to the investor to the extent of a portion of the excess depreciation.

The potential damage is compounded by the failure of the bill to relate the LTP proposal to the bill's other proposals to increase depreciation recapture, as discussed above. As now proposed, an investor partner in rental housing would be required to recognize ordinary income twice on the same dollar of accelerated depreciation.

This is the "coup de grace" to an industry which would be already well-nigh mortally wounded by the recapture and second owner-depreciation provisions. We recommend that this double penalty for investment in rental housing be eliminated.

We also recommend elimination of the excess of accelerated depreciation over straight-line as a factor in computing the allocation of deductions.

We additionally urge the committee to reject the recommendation made by the Treasury to expand LTP to include as a "tax preference" the amount to excess interest, taxes, and rent over receipts—if any—from unimproved real property during the period of construction. This militates directly against new construction.

NAHB supports the proposals in the pending bill—section 521(a)—to provide special depreciation benefits for rehabilitation of low-cost rental housing.

However, the incentive for such rehabilitation—the proposed 5-year writeoff of expenditures—is also substantially destroyed by the inclusion of such expenditures in the computation of depreciation recapture under section 1250.

We recommend that rehabilitation expenditures which qualify under this proposal be excluded from the application of depreciation recapture under section 1250.

We also urge the committee to reject the proposal of the Treasury that such expenditures be included as a "tax preference" within the LTP concept.

We object to the proposed limitation under section 412 of the bill in the use of the installment method of reporting gain to the extent that this limitation would operate on the sale of unimproved land to be used for residential construction. The proposed limitations on the installment method should be amended expressly to exempt a sale which involves unimproved real property where the taxpayer establishes that the property is bought and will be used for the construction of single family or multifamily housing.

NAHB strongly objects to the enactment of section 121 of the bill which would limit the deductions incurred by a membership organization in furnishing services to its members to the amount of income derived from members or from transactions with members. Such provision would, if enacted, severely curtail the performance by NAHB, as a membership organization, of its sole function of furthering the interests of the homebuilding industry.

The problem presented by section 121 of the bill arises with respect to the income derived by NAHB from the conduct of its annual convention, which constitutes one of the largest trade shows conducted in the United States. It is undertaken for the sole purpose of educating its members; it presents to its members the new products and techniques in the homebuilding industry to enable them to construct better and more efficient housing.

Income from the convention is derived from the rental of exhibit space to manufacturers and other organizations directly related to the homebuilding industry which, through exhibits, display such new products and techniques. While a member of NAHB seeing a product which is of interest to him may request to be contacted by the respective exhibitor at a later date, there are no sales transacted at the convention and it cannot, therefore, be considered as a "sales facility."

In most industries the rapid technological advance which this country has been experiencing makes it imperative that associations provide such "trade shows" in order that their members be kept abreast of the new developments and techniques in order to effectively operate and thereby improve business conditions in their industry. Indeed, the association conducting such "trade show" would thereby be directly promoting the common business interests of its members and more nearly achieving the purpose for which it was formed.

The proposed limitation on deductions should thus be inapplicable where, as in the case of the NAHB convention, the income is derived from an activity which "contributes importantly" to the performance by the membership organization of its express function.

We propose that this committee add to the pending legislation an amendment which would allow a taxpayer to exclude from income the first $750 of interest income on deposits in thrift institutions.

Thrift institutions are finding it increasingly difficult to attract consumer savings and we think this is one way of attracting savings.

The Internal Revenue Code currently provides a deduction for stock dividends as encouragement for investment in stocks. We believe savers require similar treatment.

Further we urge the Congress to increase the attractiveness as investment instruments of mortgages on single-family housing by giving preferred tax treatment to interest income from single-family home mortgages.

Finally, we propose that Congress condition the continued tax exemption of the income earned by pension, retirement, and similar funds on investment of a percentage of assets in residential mortgages.

The Congress should determine whether the pension funds high percentage of investment in equity risk securities is sound and in the long-term public interest. We believe that residential mortgages, now almost completely neglected by pension funds, could and should become a much safer investment resource for pension funds and that conditioning their continued tax exemption on such investment is necessary to achieve the needed shift in their investment emphasis.

The CHAIRMAN. Thank you very much.

Mr. BARBA. Mr. Chairman, I just read parts of the total statement and we are going to turn over the whole statement so it can be put in the record.

The CHAIRMAN. Your entire statement, of course, is already printed in the record.

Mr. BARBA. We ask for the inclusion in the record of these two tables on the impact of recapture under proposed revision of section 1250 and on the impact of proposed restriction on depreciation by purchaser of building acquired after July 24, 1969.

The CHAIRMAN. We will print that.

(The data referred to follows:)

I. IMPACT OF RECAPTURE UNDER PROPOSED REVISION OF SEC. 1250

[$4,000,000 apartment building, completed December 1968, 40-year useful life]

End of year	Straight line (2.5 percent)	Double declining balance (5 percent)	Cumulative depreciation		Amount of proposed recapture	Additional recapture over present sec. 1250	Additional recapture percentage
			Straight line	Double declining balance			
1	100,000	200,000	100,000	200,000	100,000	0	0
2	100,000	190,000	200,000	390,000	190,000	7,600	4
3	100,000	180,500	300,000	57,0500	270,500	43,280	16
4	100,000	171,475	400,000	741,975	341,975	95,753	28
5	100,000	164,900	500,000	905,875	405,875	162,750	40
6	100,000	154,655	600,000	1,061,530	461,530	239,996	52
7	100,000	146,925	700,000	1,208,455	508,455	325,411	64
8	100,000	139,580	800,000	1,348,035	548,035	416,507	76
9	100,000	132,600	900,000	1,480,635	580,635	510,959	88
10	100,000	125,970	1,000,000	1,606.605	606,605	606,605	100
11	100,000	119,670	1,100,000	1,726.275	626.275	626,275	100
12	100,000	113,685	1,200,000	1,839.960	639.960	639,960	100
13	100,000	108,000	1,300,000	1,947,960	647,960	647,960	100
14	100,000	102,600	1,400,000	2,050,560	650,560	650,560	100
15	100,000	99,375	1,500,000	2,149,995	649.995	649.995	100

II. IMPACT OF PROPOSED RESTRICTION ON DEPRECIATION BY PURCHASER OF BUILDING ACQUIRED AFTER JULY 24, 1969

[Assume: 10-yr.-old building purchased Jan. 1, 1970—$2,400,000 purchase price—remaining useful life, 30 yrs.]

End of year	Net income before depreciation	(0.5) 150-percent depreciation	(0.33) straight-line depreciation	Taxable income— Using 150-percent depreciation	Taxable income— Using straight-line depreciation	Additional taxable income under proposed restriction
1	$216,200	$120,000	$80,000	$92,200	$136,200	$40,000
2	218,900	114,000	80,000	104,900	138,900	34,000
3	221,600	108,300	80,000	113,300	141,600	28,300
4	224,300	102,885	80,000	121,415	144,300	22,885
5	227,000	97,740	80,000	129,260	147,000	17,740
6	229,700	92,855	80,000	136,845	149,700	12,855
7	232,400	88,210	80,000	144,190	152,400	8,210
8	235,100	83,800	80,000	151,300	155,100	3,800
9	237,800	79,610	80,000	158,190	157,800	(390)
10	240,500	75,630	80,000	164,870	160,500	(4,370)
Total						163,030

The CHAIRMAN. Mr. Barba, is not a great amount of the Federal tax involved here merely a tax on the fact that the purchasing power of the dollar has declined?

Mr. BARBA. The answer is "Yes."

The CHAIRMAN. Could you illustrate?

Mr. BARBA. Certainly. What is considered a gain and would, under the House amendments to section 1250, be taxed to a great extent as ordinary income, would in many cases represent a mere price level change. By this I mean that the cost of constructing a similar building will in many cases have increased in proportion to the increased value of the building being sold. There is in effect no real gain here, just a recognition that the inflation we have been experiencing since the Second World War, especially rampant now, has driven up the cost of everything. The brick placed in the apartment building when it was built, say 10 years ago, has gone up considerably in cost, and the wage that must be paid to the man that lays that brick has also gone up considerably. The owner of an apartment building who wants to take the so-called gain realized out of the sale of this building, and invest in the construction of a new building, needs a reasonable portion of the increased value of the old building. He needs this just in order to remain in the same relative equity position with respect to the greatly increased cost of constructing the new building as he was in with respect to the old building he just sold. This so-called gain then is not a real gain, but just a recognition that the price level has gone up as a result of inflation.

From my own experience in constructing apartment buildings, I have found that the cost of the typical apartment has increased better than 15 percent over the past few years. Unless I, as an owner of such a building, or others in the same position can realize some gain out of the building, there is absolutely nothing in profit left for me or anyone else who puts an apartment project together.

To require the recapture of all excess depreciation over straight line as ordinary income, and tax it as such, will simply serve to kill off the incentive for any person to undertake such a project.

I am representative, I believe, of the builders of this country. I am involved in all aspects of the building business. And when I find myself having to sell a project on the basis of the House-passed proposals on depreciation, I have no reason to sell; I have no reason to maintain the apartment; and, in fact, I have no reason to build it in the first place. The House provisions will kill off the incentives needed to build apartments.

We are going to need apartments more than ever in the years ahead, because of the young people in the 20 to 30 age group and the older people whose children have left home, who are increasing in number tremendously. They desire to live in apartments. If the incentive to build apartments is taken away—and the incentive under present law is not that great—then these apartments will not be built in any volume approaching the need. Those that are built will demand rents considerably higher than we are now used to, and in many cases too high to be afforded by those wo desire reasonable apartment living conditions.

What will result if we go this route will be an increased involvement of the Federal Government by way of subsidies. The higher the rent necessary to attract investment into apartments, the smaller the number of people who will be able to afford them without some type of governmental assistance. This we believe to be undesirable and we believe the Congress would agree with us.

The CHAIRMAN. Mr. Barba, what would you suggest as an alternative?

Mr. BARBA. Naturally, we would prefer to have these present provisions on recapture left as they are.

Mr. COLTON. We could submit, if agreeable, a suggestion with respect to the sliding scale amendment we could live with. We have in the past prepared it, and we could do so again.

(The committee subsequently received the following additional information:)

ALTERNATIVE SUGGESTIONS SUBMITTED BY NAHB

If it be determined to amend the applicable provision of law, notwithstanding our conviction that rental housing production will thereby be seriously constrained with gravely adverse economic and social consequences, we suggest:

1. *The concept of the limited tax preference provision,* by itself and without more, would accomplish the purpose of Congress to prevent undue tax shelter

while it would still permit a substantial (although diminished) source of needed investment capital for rental housing.

2. *With respect to recapture*, the problem of eliminating traffic in depreciation without discouraging legitimate investment in new rental housing construction can best be accomplished simply by amending existing Section 1250 to provide 5-year ordinary income treatment of *excess* depreciation instead of the present eight months, with ordinary income treatment continued at the existing diminishing rate.

3. *Second owner depreciation* should be continued at 150% of declining balance to maintain the same differential in favor of housing over other construction as is provided by the tax treatment proposed in the bill for new owners.

4. In our prepared statement we have made suggestions on other provisions in the bill and on the suggestions submitted to the Committee by the Treasury.

Senator MILLER. I am interested in this section 121 problem that you raised. In looking through the staff analysis the arguments for the House provision are as follows—and I am reading from page 30 of the blue book—"(2) This provision is necessary to prevent exempt membership organizations from attempting to avoid the effect of the unrelated business income rule by giving up their exempt status and deducting the cost of providing services for members from its investment or nonmembership income." You are talking about trade fairs. You make a profit at the trade fair, I assume.

Mr. BARBA. This depends, of course, on how you allocate your personnel and expenses. If Mr. McGrath, in drawing up the agenda for the convention spends *x* hours, that cost probably should be allocated to the convention. The same holds true for other members of the staff who spend a considerable amount of their time in preparing for our convention. So if we properly allocate our time and expenses, we probably earn a much lower amount of profit.

Senator MILLER. You are paying a tax on it. Let's assume you make a profit. Now, you would not be permitted to charge off other expenses relating to services to members. You are concerned about having to pay a tax. The argument for this provision assumes obviously that the trade fair exhibitors are not members of these organizations. Furthermore, it seems to me that the argument implies that the trade fair is not a service to members. It is income from service provided to nonmembers. I think either in the bill itself or in the committee print accompanying it should be made clear that trade fairs should be deemed to be for the service of the members. If that is so, then that is the heart of the problem. I am strongly inclined that way myself. I can see it is a mixed deal. Certainly, it is a service to an exhibitor—if he has a booth, I can see how he could get some future orders. It is also a service to members. It is a mixed situation. Obviously, the nonmembers are looking for business. But the trade fair is also a service to the members. I think we should clear up the matter.

Mr. COLTON. Practically everyone in our entire association devotes some of his time contributing to the trade show, and most of the activities of the association culminate in the convention. The entire building industry comes to the convention to see the exhibits. Many spend their entire time looking at the materials at the convention. In the past when this matter has come up we argued that there is no other way that you can bring home the new ideas. We thought we had made a case to the effect that the trade show exhibition is intertwined with the whole operation of the association, and not merely a trade show where we are providing an opportunity for sales.

Senator MILLER. I am recalling something—many State bar associations have an annual convention, and they aways have exhibits. There was a time when we had to come in for shows. It was decided that they should have to pay a fair rental for their booths. Still it was not a very large rent. The only reason for having that thing there is for the service of the members who come and have a chance to further their business. It seems to me that it would be stretching things to say that you are not going to be allowed to take a deduction. I think that is about the same ball park.

Mr. SILVERSTEIN. My name is Leonard Silverstein and I am tax counsel for NAHB. The argument is that you pay $100 to join a club and get the benefit of $300 of services.

Senator MILLER. In the same way, a member of the bar will pay his fee for going to the tax school.

Mr. SILVERSTEIN. He also gets the benefits from the profit of the show.

Senator MILLER. I understand the problem. I just want to be able to get the language drafted to cover the trade fairs in connection with conventions.

Mr. SILVERSTEIN. There are some magazines that put on shows strictly for profit.

Senator MILLER. Is that what a NAHB trade fair does?

Mr. SILVERSTEIN. There are some types of shows put on purely for profit. However, that is not true in the case of NAHB.

Senator MILLER. Where there is a trade show or an exhibition in connection with an association which provides services to the members through information or education or otherwise, then to my way of thinking that is not to be covered by this provision.

Thank you.

Mr. BARBA. Thank you.

(Mr. Barba's prepared statement follows:)

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

SUMMARY

A. *Provisions of H.R. 13270*

1. Retention of accelerated depreciation for new rental housing (Section 521(a));
2. Elimination of increased recapture of depreciation on real property (Section 521(b));
3. Elimination of restriction to straight-line depreciation by second owner of rental housing (Section 521(a));
4. Elimination of the treatment of excess of accelerated depreciation over straight-line on rental housing as a "tax preference" for purposes of the Limit on Tax Preferences of individuals (Section 301);
5. Elimination of the treatment of excess of accelerated depreciation over straight-line on rental housing as a factor in computing the allocation of deductions (Section 302);
6. Elimination of rehabilitation expenses (under Section 521(a)) from the computation of depreciation recapture on the disposition of low-cost rental housing (under Section 521(c));
7. Modification of the limitation on installment method to exempt sales of real estate purchased and used for the construction of single-family or multifamily housing (Section 412); and
8. Elimination of limitation on deductions of certain non-exempt membership organizations (Section 121).

B. Recommendations for Additional Provisions

1. Allowance of an investment account for dealers in real estate;
2. Exclusion from gross income of the first $750 of interest income on deposits in thrift institutions;
3. Preferred tax treatment for interest income from single family residential mortgages; and
4. Condition continued tax exemption of income earned by pension funds on investment of a percentage of assets in residential mortgages.

STATEMENT

Mr. Chairman and Members of the Committee, my name is Louis R. Barba. I am First Vice President and Chairman of the Legislative Committee of the National Association of Home Builders. I have with me our Tax Counsel, Mr. Leonard L. Silverstein, and our General Counsel, Mr. Herbert S. Colton.

The National Association of Home Builders consists of approximately 51,000 members in 473 affiliated state and local associations. Our members build over 75% of the residential construction in this country, including both single family housing and apartments. They thus perform a vital economic and social function—a function which the Congress has recognized and encouraged for the past 35 years.

Attached as an appendix is a more extensive statement of our views on several portions of H.R. 13270. Since our time is limited, I can sum up these views in a sentence or two:—*H.R. 13270 would completely cancel that 35-year effort insofar as rental housing is concerned. It would drastically curtail the flow of investment capital at the very time when our industry already faces critical credit problems.*

1. Recapture of Depreciation

While the bill would retain 200% accelerated depreciation on *new* rental housing, it would almost completely negate this (1) by the provisions which greatly increase recapture; (2) by restrictions on depreciation which may be taken by a second owner; and (3) by inclusion of accelerated depreciation in the limit on tax preferences and the related allocation of deductions.

The bill would practically destroy the resale market for depreciable real estate. Owners of "locked in" rental housing could not afford to sell their property at any point prior to the end of its useful life, which could be 40 years or more. This is because under the bill any sale prior thereto would result in recapture as ordinary income of the entire amount of excess accelerated depreciation over straight-line. Facing such a "lock in" developers would not dare build; investors would not find rental housing attractive; and those few wo did invest would not be able to revolve their funds for reinvestment in new construction.

We oppose Section 521(b) which removes the present concept of a cumulative percentage reduction in depreciation recapture.

2. Restrictions on Depreciation

We also object to and *recommend elimination of the provisions in the bill which would limit "second owner" depreciation on rental housing to straight-line. We recommend the existing 150 percent depreciation for second owners of residential rental housing be retained.*

This would be consistent with the proposed retention of 200% depreciation on newly constructed rental housing.

Limitation to straight-line depreciation on property in the hands of a second user penalizes rather than encourages ownership of rental housing in that the differential between the rate applicable to the *first* owner and that applicable to the second owner is greater for rental housing than for other types of buildings.

The total impact of the proposed increased depreciation recapture plus the restriction to straight-line depreciation on used rental housing, and the interaction of these two proposals, will assuredly have a disastrous effect on the housing industry. Owners of rental housing will not sell (because of the substantial depreciation recapture) and potential purchasers will not be interested in buying (because of the limitations to straight-line depreciation). Investment funds will be diverted from new rental housing—always and inherently a highly dubious investment on a pure economic basis—into other more attractive forms of investment.

3. Limit on Tax Preference and Allocation of Deductions

The home building industry supports the concept of a minimum income tax. We believe everyone in the United States should pay a fair share of taxes.

However, we think the captioned proposals would further significantly diminish the stimulation of accelerated depreciation for residential rental housing, in that they include the excess of accelerated depreciation over straight-line, as a "tax preference." The effect of such treatment under the LTP proposal would be to generate additional income to the investor to the extent of a portion of the excess depreciation.

The potential damage is compounded by the failure of the bill to relate the LTP proposal to the bill's other proposals to increase depreciation recapture, as discussed above. As now proposed, an investor partner in rental housing would be required to recognize ordinary income *twice* on the same dollar of accelerated depreciation: first under LTP in the year when excess depreciation is claimed on a property and a second time upon the later disposition of the property by the partnership.

This is the "coup de grace" to an industry which would be already well-nigh mortally wounded by the recapture and second owner depreciation provisions. *We recommend that this double penalty for investment in rental housing resulting from the inclusion of depreciation in the LTP provisions be eliminated.*

Under Section 302 of the bill, individuals would be required to allocate otherwise allowable personal deductions in such a fashion as to result in disallowance of a portion of such deductions by reason of the individual's share of the excess of accelerated depreciation over straight-line. This would further deter equity investment in rental property.

We recommend elimination of the excess of accelerated depreciation over straight-line as a factor in computing the allocation of deductions.

We also urge the Committee to reject the recommendation made by the Treasury to expand LTP to include as a "tax preference" the amount of excess interest, taxes, and rent over receipts (if any) from unimproved real property during the period of construction. This militates directly against new construction. Such expenses are integral elements of the total costs of construction and are incurred prior to receipt of rental income. This normal business activity should not be penalized. The proposal completely ignores the economic realities of construction.

4. Rehabilitation Expenses

NAHB supports the proposals in the pending bill (Section 521(a)) to provide special depreciation benefits for rehabilitation of low-cost rental housing.

However, the incentive for such rehabilitation—the proposed 5-year write-off of expenditures—is also substantially destroyed by the inclusion of such expenditures in the computation of depreciation recapture under Section 1250.

We recommend that rehabilitation expenditures which qualify under this proposal be excluded from the application of depreciation recapture under Section 1250.

We also urge the Committee to reject the proposal of the Treasury that such expenditures be included as a "tax preference" within the LTP concept. Inclusion of such expenditures would deter owners of low-cost rental housing from incurring rehabilitation expenses and completely frustrate the purpose of the proposal.

5. Installment Sales

We object to the proposed limitation under Section 412 of the bill in the use of the installment method of reporting gain to the extent that this limitation would operate on the sale of unimproved land to be used for residential construction. *The proposed limitations on the installment method should be amended expressly to exempt a sale which involves unimproved real property where the taxpayer establishes that the property is bought and will be used for the construction of single family or multifamily housing.*

Builders are hard-pressed to arrange for the acquisition of land on economically feasible terms. They need the greatest possible flexibility in the payment terms for such acquisitions. Buying land for subsequent housing developments ordinarily involves payments to the owners over a long period of years. The proposed percentage limitations under Section 412 of the bill will arbitrarily limit builders unnecessarily in their negotiations. We doubt that it was the purpose of the House that these installment method amendments apply to land purchases.

6. Non-Exempt Organizations

NAHB strongly objects to the enactment of Section 121 of the bill which would limit the deductions incurred by a membership organization in furnishing services to its members to the amount of income derived from members or from transactions with members. Such provision would, if enacted, severely curtail the performance by NAHB, as a membership organization of, its sole function of furthering the interests of the home building industry. It would similarily affect many of our affiliated state and local associations.

The problem presented by Section 121 of the bill arises with respect to the income derived by NAHB from the conduct of its Annual Convention, which constitutes one of the largest trade shows conducted in the United States. It is undertaken for the sole purpose of educating its members; it presents to its members the new products and techniques in the home building industry to enable them to construct better and more efficient housing.

Income from the Convention is derived from the rental of exhibit space to manufacturers and other organizations directly related to the home building industry which, through exhibits, display such new products and techniques. While a member of NAHB seeing a product which is of interest to him may request to be contacted by the respective exhibitor at a later date, there are no sales transacted at the Convention and it cannot, therefore, be considered as a "sales facility".

Except in the "sales facility" situation, the underlying concept of a "trade show" is that it represents an event designed to permit the interchange of knowledge for the benefit of all of its members. The exhibits represent practical workshops at which the dissemination of information as to new developments and techniques is undertaken in order to educate the members of the industry and increase their technical competence.

The "trade show" often makes it possible for members of the industry to become aware of new products and materials which have not otherwise been introduced in their geographical area. In addition, the ability to see the new products and materials in use provides a method whereby the member of the industry can determine the practical application thereof in improving the products or services of such member and his colleagues in the industry.

The non-sales facility "trade show" thus is undertaken for and in fact serves to promote the common business interest of its members through education and information on new products, materials and techniques. Moreover, in most industries the rapid technological advance which this country has been experiencing makes it imperative that the associations provide such "trade shows" in order that their members be kept abreast of the new developments and techniques in order to effectively operate and thereby improve business conditions in their industry. Indeed, the association conducting such "trade show" would thereby be directly promoting the common business interests of its members and more nearly achieving the purpose for which it was formed.

The proposed limitation on deductions should thus be inapplicable where, as in the case of the NAHB Convention, the income is derived from an activity which "contributes importantly" to the performance by the membership organization of its express function.

7. Incentives for Housing

This bill before you presents Congress with a unique opportunity to provide the people of the United States with improved opportunities for attaining the Nation's housing goals. The great problem facing the industry currently is a severe lack of mortgage funds. There is every reason to believe this will continue in the foreseeable future.

We propose that this Committee add to the pending legislation an amendment which would allow a taxpayer to exclude from income the first $750 of interest income on deposits in thrift institutions.

Thrift institutions, primarily savings banks and savings and loan associations, are the primary source of funds for the home building industry. They are finding it increasingly difficult to attract consumer savings because of the competition from other sources offering higher rates than thrift institutions can afford to pay.

The Internal Revenue Code currently provides a deduction for stock dividends as encouragement for investment in stocks. We believe savers require similar treatment.

Further we urge the Congress to increase the attractiveness as investment instruments of mortgages on single family housing by giving preferred tax treatment to interest income from single family home mortgages.

The single family mortgage instrument in today's economic and inflationary climate has completely lost its attractiveness to investors. The national monetary policies for controlling inflation have fallen with catastrophic impact upon the source of mortgage funds for single family home mortgages. The nation can ill afford to have the single family housing industry largely destroyed or curtailed during this current period. Such preferred tax treatment would not only be consistent with the stated national policy of encouraging home ownership, but it will also enable the single family home industry to better ride out periods of severe monetary restraint such as we are now in.

We propose that Congress condition the continued tax exemption of the income earned by pension, retirement, and similar funds on investment of a percentage of assets in residential mortgages.

Pension funds are the fastest growing pool of savings in the country. The Congress should determine whether their high percentage of investment in equity risk securities is sound and in the long-term public interest. We believe that residential mortgages, now almost completely neglected by pension funds, could and should become a much safer investment resource for pension funds and that conditioning their continued tax exemption on such investment is nessary to achieve the needed shift in their investment emphasis.

Appendix

Detailed Statement of the National Association of Home Builders Before the Committee on Finance, U.S. Senate on H.R. 13270

The National Association of Home Builders is the trade associate of the home building industry. Our membership totals approximately 51,000 members who are grouped in 473 affiliated state and local associations and who build over 75 percent of the residential construction in this country. As such, our members have a basic interest in providing adequate housing (both single and multifamily) for all Americans in all income levels at prices and rents they can afford.

Our members therefore have a vital interest in several of the provisions of H.R. 13270, the Tax Reform Act of 1969, which we feel would substantially impair the flow of investment funds into, and the construction of, multifamily rental housing units which this country has committed itself to by the enactment of the Housing and Urban Development Act of 1968. We are concerned that the enactment of these provisions would drastically diminish new multifamily construction and require substantially higher rents on the small amount that would be produced, thereby, of course, raising rental levels generally. It would thus be contrary to the national policy, repeatedly stressed by the Congress, to encourage the construction of necessary housing. It would materially add to the economic difficulties faced by this vital industry in the current critical inflationary crisis.

I. Provisions Affecting Home Building Industry

1. *Accelerated Depreciation for Residential Housing* (Sec. 521(a) of the Bill)—We endorse the provisions of Section 521(a) which ostensibly recognize the importance of residential housing within the economic structure of this nation by retaining the availability of accelerated methods of depreciation with respect to rental housing. This retention of accelerated depreciation with respect to housing is vital in order to provide the flow of investment funds necessary for construction of such property.

However, the purpose underlying the retention of accelerated depreciation for rental housing is almost completely negated by the interaction of Section 521(a) with the following provisions of the Bill: (i) increase in depreciation recapture (Section 521(b)); (ii) restriction on depreciation by purchaser (Section 521(a)); (iii) limit on tax preferences for individuals (Section 301); and (iv) allocation of deductions by individuals (Section 302).

2. *Recapture of Depreciation* (Sec. 521(b) of the Bill)—Under present law, gain on the sale of buildings is taxed as ordinary income to the extent of the depreciation taken on the property after December 31, 1963; however, after the property has been held 12 months, only the excess of accelerated depreciation over straight-line is "recaptured" as ordinary income. The amount of recapture

is then reduced after 20 months at the rate of 1 percent per month so that there would be no recapture where the property has been held for ten years.

Section 521(b) of the Bill would amend Section 1250 of the Code to remove the percentage reduction of the amount of recapture. Thus, where a building is sold after July 24, 1969, the entire amount of accelerated depreciation in excess of straight-line taken after July 24, 1969 would be recaptured as ordinary income to the extent of the gain realized on the sale, regardless of the length of time for which the property was held. The effect of such provision would be to apply to real estate depreciation recapture rules which are substantially similar to those applicable to personal property. However, this ignores the fact recognized by this Committee in 1964 that the circumstances of price level changes in real estate are far more severe than occurs in the case of personal property. Asserted gains which occur with respect to realty held for long periods of time often, in fact, represent mere price level changes. In such event, no economic gain, justifying a reversal of a previously granted deduction occurs. This is especially true in times of rapid inflation such as we are now experiencing.

The economic effect of this provision would be to substantially reduce the yield otherwise available from an investment in real estate and thereby impede the flow of necessary capital into the construction of rental housing. Moreover, the enactment of such a provision would produce a significant "lock in" effect, in that owners of existing rental housing would be unwilling to sell the property at any point prior to the end of its useful life (40 years or more), since a sale prior thereto would result in recapture as ordinary income of the entire amount of the excess of accelerated depreciation over straight-line. This is particularly true where the asserted gain arises from mere price level changes. This will have a substantial impact in the case of rental housing held for ten to twenty years. The owner's investment in such property will thus remain non-liquid and unavailable for investment in the construction of new residential rental property which will be necessary to meet the needs of our expanding population at such future time.

3. *Restriction on Depreciation by Purchaser* (Sec. 521(a) of the Bill)—The likelihood of a "lock in" effect produced by the full recapture of the excess of accelerated depreciation over straight-line regardless of the period for which the building is held is enhanced by the provisions of section 521(a)(4) which would limit to straight-line the depreciation which could be taken on section 1250 property, including rental housing, acquired after July 24, 1969, where the original use of such property does not commence with the taxpayer.

We are mindful of the fact that under our tax laws, depreciation available to a "second user" of property has been at a rate less than that available to the original user. Under present law, the second user cannot avail himself of the double declining balance or sum-of-the-years digits methods of depreciation on such property, but is instead limited to a maximum of 150 percent of straight-line. Consistent with such past precedent, since the Bill limits depreciation on buildings other than rental housing to 150 percent of straight-line, it would appear appropriate to apply the straight-line limitation to the second user of such buildings. However, since the Bill retains the availability of the accelerated methods of depreciation with respect to rental housing, the proposed limitation on depreciation to straight-line of such property by the second user in fact penalizes rather than encourages ownership of rental housing by curtailing depreciation by the second user at a rate which is in fact *greater* than the curtailment with respect to the second user of other buildings. Since H.R. 13270 specifically recognizes the economic necessity of a preferred status for rental housing, it is clearly inconsistent therewith to penalize the second user of such rental housing by providing identical treatment to that of the second user of other buildings.

The interaction of increased depreciation recapture and the restriction on depreciation to straight-line in the hands of the second user would have an adverse effect on the housing industry since owners of rental housing will not sell (in view of the substantial depreciation recapture) and potential purchasers will not buy (in view of the limitation to straight-line depreciation on such property). This "lock in" effect will result in channeling of investment funds into more attractive forms of investment and preclude construction of necessary new rental housing in later years.

4. *Limit on Tax Preference of Individuals* (Sec. 301 of the Bill)—The continued availability of accelerated depreciation for rental housing would be further and significantly eroded by the proposed limit on tax preferences ("LTP") which treats the individual's share of the excess of accelerated depreciation over

straight-line taken on section 1250 property, including rental housing, as one of several designated "tax preferences". Under this formula, an individual investor who provides equity capital to a partnership for the construction of rental housing would be required to treat as a "tax preference", in each taxable year, his proportionate share of the excess of accelerated depreciation over straight-line taken on the rental housing owned by the partnership. The taxpayer would then determine the total of his "items of tax preference" for such year and the LTP would be the greater of one-half of the sum of (i) the items of tax preference and (ii) the adjusted gross income, or $10,000. The excess of tax preferences over the LTP would be the disallowed tax preference which amount would be required to be added to gross income in determining the taxpayer's taxable income for such year.

The effect of treating accelerated depreciation over straight-line on rental housing as a "tax preference" for purposes of the LTP computation will be to discourage the investment of equity capital required for the construction of this much needed housing. Rather than invest in rental housing with all its otherwise attendant economic risks, an outside investor, faced with additional taxable income in the form of the excess depreciation, will instead channel his funds into other forms of investment which would not generate such additional taxable income, thereby depriving the housing industry of the needed source of outside capital. This will impede rather than permit accomplishment of our housing goals as reflected in the Housing and Urban Development Act of 1968.

Moreover, the potential damage to rental housing is compounded by the failure of the Bill to completely interrelate the LTP mechanism with the previously described increase in depreciation recapture. Assuming, as is most often the case, the rental housing is owned by a partnership, the investor partner may be required to include in gross income under LTP his proportionate share of the excess of accelerated depreciation over straight-line in each year. When the partnership later disposes of the property (e.g., after 12 years), there will be full recapture at ordinary income rates on the excess of accelerated depreciation over straight-line taken by the entire partnership to the extent of the gain realized on such disposition. By operation of the partnership provisions of the tax law, the partnership is a conduit and it is the partners who bear the burden of depreciation recapture.

However, no complete mechanism is provided to permit the investor partner to receive full credit, against his share of ordinary income represented by depreciation recapture upon the disposition of the residential rental property by the partnership, for the amount of ordinary income which he was required to include in gross income under LTP in each of the years during which the partnership held the property prior to sale. The Bill provides that the disallowed tax preferences attributable to accelerated depreciation will increase the "basis of the asset to which they relate" for purposes of determining gain or loss upon the disposition thereof (and not for purposes of computing depreciation thereon). In a factual situation involving a partnership, the "asset" for this purpose would likely be the rental housing itself, so that the investor partner's interest in such property would be increased by the disallowed depreciation required to be included in his income under LTP. (This result is by no means certain since the "asset" in question could be the investor's partnership interest). Under this approach, the partner's share of gain on the disposition of the property by the partnership would be reduced by reason of the increase in his share of the basis of the property. However, since depreciation recapture would be the lesser of gain or the excess of accelerated depreciation over straight-line, the increase in basis will not provide the partner with an offset to depreciation recapture where the gain is greater than the excess of accelerated depreciation over straight-line taken on such property.

The investor partner may thus be required to recognize ordinary income *twice* on the same dollar of accelerated depreciation, i.e., first, under LTP, in the year in which the excess depreciation over straight-line is claimed on the property by the partnership, and, second, on his share of depreciation recapture upon the later disposition of the property by the partnership. This result would serve to deter the flow of investment funds into rental housing and negate the objective sought to be achieved by retaining the availability of accelerated depreciation for such property.

5. *Allocation of Deductions* (Sec. 301 of the Bill)—A further deterrent to investment in the construction and ownership of rental housing is provided in section 302 of the Bill which would require the allocation by an individual of

otherwise allowable personal deductions (including interest, taxes, charitable contributions, and medical expenses) and result in a disallowance of the portion thereof attributable to allowable tax preferences, including the excess of accelerated depreciation over straight-line on residential rental housing. The portion of the excess of the individual's share of accelerated depreciation over straight-line for a taxable year which is not disallowed and added to his gross income under LTP is used in determining the portion of such deductions which is disallowed for such taxable year. The portion of the otherwise allowable deductions for such expenses (other than charitable contributions) to be disallowed by reason of the individual's share of the excess of accelerated depreciation over straight-line on rental housing (and other tax preferences) could not be carried forward and claimed as deductions in a later taxable year.

The effect of the enactment of the above-described provisions would be to impose severe tax restrictions which, together with present financial restraints, would seriously impair the ability of our industry to provide the necessary rental housing for our fellow citizens.

Instead of assisting the home building industry in its efforts to meet the critical housing needs of this Nation, the enactment of these provisions would effectively deter equity investment in the construction of residential rental housing. These proposals (a) penalize the equity investor by utilizing the excess of accelerated depreciation over straight-line on rental housing to result in a double inclusion of income by such investor (through LTP in each year and through increased depreciation recapture in the year of disposition), and a disallowance of personal expenses wholly unrelated to his investment in the rental housing, and (b) create a "lock in" effect as to investment in existing rental housing.

It is therefore imperative that this Committee, recognizing the critical nature of the Nation's housing needs, significantly revise the above-described provisions of H.R. 13270 which would operate to deprive the home building industry of equity capital which is the life blood of its continued operation.

Moreover, we urge that this Committee reject the recommendation made by the Treasury representatives during their presentation before this Committee to expand the LTP concept to include as a "tax preference" the amount of the excess of interest, taxes and rent over receipts (if any) from unimproved real property during the period of construction of improvements. The Treasury indicated that such amounts are "part of the economic cost of the improvement and when allowed as a deduction result in excesesive tax benefits to some high-bracket investors". The treatment of such expenses as tax preferences so as to result in additional income to the investors will serve as another severe deterrent to the flow of investment funds into the construction of rental housing and thereby contribute further to the decline in he construction of such housing.

Such expenses are incurred as integral elements of the overall cost of construction at a time which of necessity is prior to completion of the improvements on such real property and thus prior to the receipt of rental income to be derived from the improvements. These expenses are a necessary incident to the construction of the improvements and should not be subject to penalty solely by reason of the fact that they are of necessity incurred prior to the production of income from the improvements. The treatment of such expenses as a "tax preference" fully ignores the economic realities of the construction of rental housing and other improvements and fails to recognize that the investment of owner is earning no return during the construction period. The excessive tax benefits asserted by the Treasury to result from such expenses are instead an ordinary and necessary part of the construction activity and their effective disallowance (by the treatment thereof as additional income to the individuals) will serve to further preclude the Nation from meeting its commitment for the construction of necessary housing.

6. *Rehabilitation Expenses* (Sec. 521(a) of the Bill)—The Bill provides for the depreciation on straight-line method over a period of 60 months of expenditures (having a useful life of 5 years or more) for the rehabilitation of low-cost rental housing, up to a maximum of $15,000 per dwelling unit (apartment). The purpose of this provision is to stimulate and encourage rehabilitation of buildings for low-cost rental housing. NAHB has consistently favored the enactment of a provision of this type in order to provide an incentive for improvement of the living conditions of the economically deprived members of our society.

However, the incentive for such rehabilitation provided by the five-year write-off of rehabilitation expenditures is substantially negated by the inclusion of such expenditures in the computation of depreciation recapture under section 1250. Under Section 521(c) of the Bill, the amount of depreciation recapture upon the sale of low-cost rental housing would include the entire amount of rehabilitation expenditures to which the five-year write-off was applicable or, where the housing was sold after one year, the excess of the depreciation under the special write-off over the depreciation which would have otherwise been allowable on such expenditures, if the useful life had been determined under normal rules. Thus, the owner of such low-cost housing would be required to recognize ordinary income solely by reason of improving the facilities in such low-cost housing.

The inclusion of rehabilitation expenditures to which the special five-year write-off would be applicable within the operation of depreciation recapture is contrary to both the technical requirements of section 1250 of the Code and the purpose underlying special write-off of rehabilitation expenditures. Section 1250 by its terms is intended to recapture only the amount of depreciation which is claimed in excess of the amount otherwise available if the straight-line method were utilized. Section 1250 was never intended, and does not in fact operate, to result in depreciation recapture where depreciation on the building is determined under the straight-line method. Since the special write-off of rehabilitation expenditures expressly provides that it is a depreciation under "the straight-line method" using a useful life of sixty months, there is, in fact, no amount of depreciation *in excess* of straight-line to which section 1250 should be applicable. Furthermore, since the purpose of the proposed write-off of rehabilitation expenditures is to encourage such expenditures, the fact that the taxpayer will be faced with ordinary income (in the form of depreciation recapture) upon the disposition of such low-cost rental housing will significantly deter his incurring such rehabilitation expenditures and thereby defeat the underlying purpose of the special write-off.

We therefore recommend that the rehabilitation expenditures which qualify for depreciation under the five-year write-off provided in Section 521(a) of the Bill should be excluded from the application of depreciation recapture.

Moreover, we urge this Committee to reject the proposal made by the Treasury during its testimony before this Committee that the rehabilitation expenditures under the five-year write-off be included as a "tax preference" within the LTP concept. The allowance of depreciation on such expenditures over a five-year period was not recommended by the House in order to create a "tax preference" which could result in additional income under LTP as a result of incurring such expenditures, but rather as a recognition of the necessity for a tax incentive to encourage the improvement of existing low-cost rental housing. The potential ordinary income which would result from the combined effect of treating such rehabilitation expenditures as part of LTP and as part of depreciation recapture would produce an *"overkill"* which would deter the owner of low-cost rental housing from incurring such rehabilitation expenditures and thereby completely frustrate the purpose underlying this provision.

7. *Limitation on Installment Sales Provision* (Sec. 412 of the Bill)—We object to the proposed limitation of the election of the installment method of reporting gain to designated "installment transactions" to the exent that such limitation would operate to preclude installment reporting of gain on the sale of unimproved land to be used for the construction of housing, both single family and multifamily. Under Section 412 of the Bill, the installment method of reporting provided in section 453 of the Code would be available only to gain on a transaction in which payments of principal or principal and interest are required to be paid periodically and in such amounts over the installment period as prescribed under regulations by the Secretary. Such requirement will be deemed satisfied if (i) such payments are required to be made at least once every two years in relatively even or declining amounts over the installment period; or (ii) at least 5 percent of the principal is required to have been paid by the end of the first quarter of the installment period, at least 15 percent of the principal is required to have been paid by the end of the second quarter of the installment period, and at least 40 percent of the principal is required to have been paid by the end of the third quarter of the installment period. The Ways and Means Committee Report provides that this "latter safe-haven rule should protect legitimate installment sale transactions."

We believe, however, that the importance of ensuring the availability of an adequate supply of land for the construction of housing necessary to meet the Nation's housing needs should be given special consideration in qualifying for installment method of reporting gain on the sale thereof. In view of the substantial increase in the cost of land created by our inflationary economy, builders are hard-pressed to arrange for the acquisition of land on terms which are economically feasible. Acquisition of land under such adverse economic conditions requires that the builder have the flexibility to make the acquisition on terms which permit payment over a period of years other than within prescribed percentage limitations while still permitting the seller to report the gain on the installment method. A limitation on the qualification for installment reporting to sales involving periodic payments qualifying within the strict confines of designated percentages as proposed in Section 412 will substantially impede the ability of builders to acquire land for construction of housing which is desperately needed in this country.

We therefore believe that the proposed limitations on the installment method should be amended to expressly exempt therefrom a sale involving unimproved real property where the taxpayer establishes that the property is purchased and will be used for the construction thereon of housing.

II. Provisions Affecting NAHB

Limitation on Deductions of Certain Non-Exempt Membership Organizations (Sec. 121 of the Bill)—NAHB strongly objects to the enactment of section 121 of the Bill which would limit the deductions incurred by a membership organization in furnishing services to its members only to the amount of income derived from members or from transactions with members. Such provision would, if enacted, severely curtail the performance by NAHB, as a membership organization, of its sole function of furthering the interests of the home building industry. The provision could have the same effect on many of our affiliated local and state associations.

The problem presented by section 121 of the Bill arises with respect to the income derived by NAHB from the conduct of its annual Convention. This Convention, which constitutes one of the largest trade shows conducted in the United States, is undertaken for the sole purpose of educating its members as to the new products and techniques in the home building industry so as to permit its members to construct better and more efficient housing. The income from the Convention is derived from the rental of exhibit space to manufacturers and other organizations directly related to the home building industry which, through exhibits, display such new products and techniques. While a member of NAHB seeing a product which is of interest to him may request to be contacted by the respective exhibitor at a later date, there are no sales transacted at the Convention and it cannot, therefore, be considered as a "sales facility."

Except in the "sales facility" situation, the underlying concept of a "trade show" is that it represents an event designed to permit the interchange of knowledge for the benefit of all of its members. The exhibits represent practical workshops at which the dissemination of information as to new developments and techniques is undertaken in order to educate the members of the industry and increase their technical competence. The "trade show" often makes it possible for members of the industry to become aware of new products and materials which have not otherwise been introduced in their geographical area. In addition, the ability to see the new products and materials in use provides a method whereby the member of the industry can determine the practical application thereof in improving the products or services of such member and his colleagues in the industry.

The non-sales facility "trade show" thus is undertaken for and in fact serves to promote the common business interest of its members through education and information on new products, materials and techniques. Moreover, in most industries, the rapid technological advance which this country has been experiencing makes its imperative that the associations provide such "trade shows" in order that their members be kept abreast of the new developments and techniques in order to effectively operate and thereby improve business conditions in their industry. Indeed, the association conducting such "trade show" would thereby be directly promoting the common business interests of its members and more nearly achieving the purpose for which it was formed.

It is submitted that the proposed limitation on deductions should thus be inapplicable where, as in the case of NAHB Convention, the income is derived from an activity which "contributes importantly" to the performance by the membership organization of its express function. The purpose of section 121 of the Bill is to preclude the use of investment income to offset the loss from conduct of membership operations. Where, however, the income is derived from the performance of an activity (rather than a passive investment) which is related to the fulfillment of its functions, the membership organization is not in fact utilizing unrelated income to offset operating expenses.

Since the purpose of the Convention which generates such income is directly related to, and contributes importantly to, the performance of the underlying purpose of NAHB itself, there should be no limitation placed on the application of such income against expenses of operation of the organization. Indeed, such result would be inconsistent with judicial decisions permitting such offset and would, in the case of NAHB, do violence to its purpose by impeding its ability to provide its members with a form of services, i.e., the knowledge of the latest techniques and products, which would thereby improve the quality of the housing which this country so desperately needs at the present time.

III. Other Recommendations

1. Investment Accounts for Dealers in Real Estate.—We recommend that as part of its consideration of the overall subject of tax reform, this Committee add to H.R. 13270 a provision of vital importance to the home building and real estate industry which would provide for investment accounts for dealers in real estate.

Unlike persons who deal in securities, persons who engage in the realty and home building businesses have no statutory grant (such as provided in section 1236 of the Code for dealers in securities) to earmark realty as investment property, and thereafter dispose of such property as a capital asset.

As a result, the courts have generally precluded home builders from capital gains treatment on realty even under circumstances where the property involved was purchased and sold in unimproved state. The home builder may prevail under present law only by introducing facts sufficient to establish that such realty was not held principally (or of first importance) for the purpose of sales to customers in the ordinary course of business. The judicial decisions, however, create substantial uncertainty as to the tax treatment of realty acquired for investment rather than for development purposes in a given factual situation.

The purpose of such provision would be to remove the existing uncertainty and create express statutory rules which, if satisfied, would permit an electing home builder to make genuine investments in realty and thereafter dispose of such property with a clear assurance of taxation on the gain thereof as a capital gain. Under this provision, in the case of a dealer in real property, the gain derived from the sale of certain property, could at his election, quality for capital gains treatment as gain derived from the sale of exchange of a capital asset.

Adequate safeguards would be provided in the proposal in order to insure that such provision would be applicable only to realty which was held for investment purposes. The category of real property which would qualify under this provision would be limited to property held by the taxpayer for more than 18 months, on which no substantial improvement (i.e., expenditures of no more than 15 percent of the market value of such property) was made during the holding period, and as to which the taxpayer, within 30 days of acquisition, clearly identifies such property as real property held for investment. The manner of such identification would be prescribed by the Secretary or his delegate.

Legislation generally similar to the above is now part of the Code (section 1236) and applies in the case of securities dealers. NAHB believes that home builders and dealers in real estate should be entitled to the same certainty of tax treatment.

2. Incentives for Housing.—This bill presents the Congress with a unique opportunity to provide the people of the United States with improved opportunities for attaining the Nation's housing goals. These goals, set out in the Housing and Urban Development Act of 1968, call for the construction and rehabilitation of 26 million housing units over a ten year period from 1968 to 1978. To meet these goals, it is necessary to produce at an average annual level of 2.6 million housing units. Today we are producing at less than half of that needed average annual level.

The home building industry, because of tight money and excessively high interest rates, is unable to produce anywhere near the volume required to meet these goals and in fact every month is falling further and further behind with an ever declining production level. To encourage the availability of the mortgage money needed to enable our industry to construct the housing needed and desired by the citizens of this country, it is recommended that the following three tax incentives be enacted:

(a) *Allow a taxpayer to exclude from income the first $750 of interest income on deposits in thrift institutions*—Thrift institutions, primarily savings banks and savings and loan associations, are the primary source of funds for the home building industry. They are finding it increasingly difficult to attract consumer savings because of the competition from other sources offering higher rates than thrift institutions can afford to pay.

(b) *Give preferred tax treatment to interest income from single family home mortgages*—The single family mortgage instrument in today's economic and inflationary climate has completely lost its attractiveness to investors. The national monetary policies for controlling inflation have fallen with catastrophic impact upon the sources of mortgage funds for single family home mortgages. The Nation can ill afford to have the single family housing industry largely destroyed or curtailed during this current period. Providing preferred tax treatment on the interest income earned on these mortgages is believed fully consistent with the stated National policy encouraging homeownership. It will also enable this industry to better ride out periods of severe monetary restraint such as we are now in.

(c) *Condition the continued tax exemption of the income earned by pension, retirement, and similar funds on investment of a percentage of assets in residential mortgages*—Pension funds are the fastest growing pool of savings in the country. The Congress should determine whether their high percentage of investment in equity risk securities is sound and in the long-term public interest. We believe that residential mortgages, now almost completely neglected by pension funds, could and should become a much safer investment resource for pension funds and that conditioning their continued tax exemption of such investment is necessary to achieve this needed shift in their investment emphasis.

The CHAIRMAN. The next witness now will be Carl M. Halvorson, president of the Associated General Contractors. Mr. Halvorson, we are familiar with your fine organization. They do a great job and we welcome you here today.

STATEMENT OF CARL M. HALVORSON, PRESIDENT, ASSOCIATED GENERAL CONTRACTORS

Mr. HALVORSON. Thank you very much, Senator.

We have filed a statement with the committee. I won't take the time of the committee to read any of the portions of the testimony that have been submitted, but I would like to make a few general remarks in regard to the bill.

Inasmuch as our membership does somewhere in the area of 75 percent of the contract construction in this country, and much of this construction is in the field of building for various owners of real estate, including housing, commercial buildings, factories, and all the various things that we have for shelter and work space in this country, we are very much concerned with this substantial part of our market. We feel that the retention of the existing rules on depreciation, and on recapture, is a good manner of handling this kind of problem in our society. And we feel further that the disruption of changing these rules would not be to the best interests of our country.

Now, also, there are so many other things in the bill that have an effect on what it costs to do the work in building these buildings and the various public works, that we think that serious consideration should be given to allowing the depletion, for instance, on sand and gravel to stay the way it is.

We believe that tax-free local bonds are essential to create public works. Public works tie this society together, by providing buildings and other types of improvements at the local level. To change the taxing structure on these bonds would inure to the detriment of all real estate activity within the country.

Also, we feel that another important factor of cost of a building, or any kind of structure or public improvement, is the depreciation allowable on our equipment used in the construction thereof. As you know, Congress has changed the law regarding gains on sale of depreciable equipment, so that now such gain is ordinary income to the extent of depreciation taken thereon after 1961. We feel that the operator of a business should be free to use his own best judgment to set the depreciable lives of his equipment. From a broad, long-range position, the Government would not suffer, and such a rule would permit the private operator more flexibility in arriving at depreciation rates to fit his particular use of equipment.

In many cases over the years we have had to buy special tools to do a special job. We have to charge the cost of those tools against that special job. Consequently, we feel that we should be able to recover in depreciation what we charge against that particular item.

We feel, further, that anything that makes a substantial change in the basis on which our economy is run does tend to have a disruptive influence on the overall posture. Consequently, there must be compelling reasons for making these changes or there will be disruptions.

We are actually in a depressed situation in our construction industry right now, despite the fact that there is much work in the "pipeline," so to speak, that has been created in past years. Commercial building, for instance, in the 11 Western States is down 20 percent at present, and public works are down almost 50 percent from what they were a year ago. In view of the cutbacks and other activities that have come out in the past couple of weeks, we think there will develop a very serious situation in the construction industry, which is the largest single industry in this country, within a very short time. Work which presently is underway is very substantial, but, as the work in the "pipeline" depletes itself, we think that we will have very serious problems in this industry.

So, with that, I would conclude my remarks. As I say, we have gone into these factors in detail in the statement. I didn't want to burden you with restating those specific points.

The CHAIRMAN. Thank you very much, sir.

Mr. HALVORSON. Thank you very much.

(Mr. Halvorson's prepared statement follows:)

STATEMENT OF CARL M. HALVORSON, PRESIDENT, THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

SUMMARY

The 9,000-member firms of The Associated General Contractors of America comprise one of the most significant and most basic of industries. The economic history of the last twenty years amply demonstrates the intimate connection between our health and that of the entire American economy.

As the Congress and the nation undertake this significant reexamination of national tax policy, the members of our association have become increasingly concerned over the multiplicity of recessive measures, not fully thought through in terms of the tax policy, whose primary effect will be upon the construction business.

Existing Depreciation and Recapture Rules Should Be Retained for All Real Estate

Section 521 of H.R. 13270 would deny all accelerated depreciation to used property and restrict depreciation of new nonresidential property to the 150 percent declining balance method.

In doing so Section 521 ignores that the greatest economic wastage of real property occurs in the early years of ownership, and that double declining balance and sum of the years-digits depreciation are necessary to allow recovery of this capital shrinkage. Although opponents of accelerated depreciation rely on data which shows resale prices in excess of adjusted basis, this spread is true capital gains, fully accounted for by the immense inflation in construction costs—more than 30 percent in the last five years and 15 percent just since January 1968—and by the growing scarcity of urban land. The cash flow produced by depreciation—the other factor said to support Section 521—is amply justified by the need to service mortgages in an ever tightening money market and the needs for reserves which are constantly used to renew the property.

Section 521, furthermore, misses the abuses at which it is supposedly aimed. For sound reasons apart from tax policy. new residential construction is exempted from the proposed strictures on accelerated depreciation, even though it is such real estate that is most open to the rapid turnover which is the key to any tax abuse. This part of Section 521 would apply only to industrial and commercial structures, where the opportunities for abuse are negligible and where restrictions on depreciation will greatly decrease the ability of American business to meet foreign competition. Indeed, in this respect Section 521 is directly at odds with the approach of Section 221 of the House bill. That part, in establishing limitations on the interest deduction, recognizes that expenses incurred in a trade or business are not susceptible to abuse and expressly exempt interest incurred in the conduct of a trade or business.

Nor has any cogent case been made for the recapture rules that Section 521 would impose. We did not oppose the adoption of Section 1250 in 1964 because we believed then and believe now that it provides a rational and fair inhibition upon the tax abuse that can exist in this area by measuring the recapture of depreciation into ordinary income by the length of the taxpayer's holding period. Section 1250 presents a carefully designed tool that is entirely responsive to the difficulties that existed. H.R. 13270, on the other hand, would convert all depreciation above straight line to ordinary income upon the sale of real estate, and thereby penalize a bone fide long term investor who has not abused the tax laws and seriously restrict the amount of capital that will be placed into construction of modern facilities.

The Need For Reform of Capital Recovery Rules

The most notable and most serious omission from H.R. 13270 is the absence of the long promised general reform of our capital recovery system. Against the background of the proposed repeal of the investment credit, this reform is more necessary than ever.

The cost of machinery is a major factor in the construction industry, and the five year life applied to most of our equipment ignores the exteraordinarily abusive working conditions and rate of technological change that makes our equipment substantially useless after a year or two of use. For much of the last several years, the investment credit has compensated for the unrealistic useful lives applied in our industry. If contrary to the repeated assurances we have heard in prior years, the credit is not to be a permanent part of our tax structure, there must at the same time be a general reform of capital recovery rules for all industry.

That reform must recognize three principles.

First, average lives must be based upon the optimum practice for each industry. Otherwise the tax code will forestall industrial modernization and build obsolescence into American industry. All American business will suffer an increased disadvantage in competing abroad, where rapid capital recovery has long been a principal tenet of tax and economic policy.

Second, depreciation rules must recognize that some taxpayers have a particular need for rapid replacement. Now that the moratorium on the reserve ratio test is ended, revenue agents will see themselves free to renew the endless haggling over depreciable lives that marked audits for so many years, unless the Congress emphasizes that a businessman's reasonable decision of how to manage his own business should be given the strongest weight.

Third, changes in the depreciable lives must not be viewed as revenue gathering or contracyclical devices. For thirty years our economy was hampered by restrictive depreciation rules based on a depression decision to raise more money by lengthening useful lives. This is poor tax policy and disastrous economics. Depreciation reform should provide a context that invites steady capital investment and provides an assured permanence of statutory structure.

The specifics of depreciation reform should start with four proposals which the machine tool industry previously described for this committee.

Two, elimination of the reserve ratio test and the amendment of Section 167 to eliminate the need to establish salvage value, would simplify tax accounting, eliminate endless controversies on audit, and recognize that in the construction business as elsewhere there is no predictable or readily available salvage market for many capital goods.

The third proposal, to codify the guideline depreciable lives, is highly meritorious, but the Congress should recognize (1) that the guidelines are unnecessarily restrictive in their treatment of the construction industry; (2) that three years rather than five years is a realistic average life for construction equipment; and (3) that some contractors in some situations require even shorter lives.

The fourth proposal—to eliminate the $10,000 ceiling upon the additional first year depreciation allowance of Section 179, with a possible reduction in rate—would help compensate for the loss of cash flow that will follow repeal from the investment credit. An amendment of Section 179(d)(1) to grant the allowance without regard to the useful life of depreciable property would be particularly equitable in its application to the construction industry.

Interest on the Obligations of State and Local Governments Should Remain Tax Exempt

A significant portion of the business of members of our association consists of public construction. By disrupting the financial market for state and local securities—and the financial press shows how severely the House passage of H.R. 13270 has restricted the marketability of these securities—the inclusion of interest on these obligations within the tax preference provisions of the bill will destroy the ability of local governments to supply necessary facilities and services.

We agree that each American should pay some taxes on his economic income. It is incorrect, however, to include interest on state and local securities in the catalog of items not carrying their fair tax burden.

The holder of these securities pays a silent tax, measured by the difference between the interest he receives and the greater interest available on nonexempt securities. Interferences with the tax exempt status of public securities will require a compensating increase in state and local taxes, and there will not be commensurate increases in federal tax collections. This "reform" will increase everyone's taxes and decrease no one's; there is no justification for its enactment.

The Existing 5 Percent Depletion Rate for Sand and Gravel Should Not Be Reduced

For reasons that are unexplained, H.R. 13270 would impose a 20 percent reduction in the smallest depletion rate in the tax code: the 5 percent rate accorded sand and gravel.

Sand and gravel producers face a staggering need to find and develop new supplies in the last third of this century. The average annual output must be doubled to satisfy projected demands. Cost of development and production are particularly high, since deposits must be developed near construction sites and their proximity to metropolitan areas requires extensive expense for rehabilitation after the sand and gravel is removed.

The proposed reduction in depletion rate can only increase the cost of construction contractors, who are the primary consumers of sand and gravel. Both considerations of tax policy and the economics of an industry that has already suffered immense inflation in cost require continuation of the 5 percent rate.

The "Country-By-Country" Limitation On Foreign Tax Credit Should Not Be Changed

Section 431 of the House bill would impose an additional inhibition on the ability of smaller businesses—those who lack a large base of foreign income—to compete abroad. The danger perceived—the possibility of a double tax benefit for those who have loss years followed by successful years in foreign countries—exists only for activities in countries not allowing loss carryovers in their tax structure.

But the effect of the denial of the carryover is to increase the effective tax rate in those countries, and the limitation of the American tax credit in turn would increase the effective total tax burden beyond the amount the American tax code would impose on the net results of the foreign business. Thus, this provision not only would impair the United States' position in foreign commerce, but it also would frustrate a prime function of the foreign tax credit.

H.R. 13270 Would Subject the Construction Industry To a Multiplicity of Recessive Yet Inflationary Pressures

Each of the parts of H.R. 13270 which I have discussed would inhibit new construction, raise the cost of construction, or both. H.R. 13270, if not changed, will subject the construction industry together with the entire economy to a multiplicity of pressures that are both recessive and inflationary. These parts of H.R. 13270 are not sound as tax reforms, they are economically dangerous, and they should not survive the scrutiny of the Senate.

STATEMENT

My name is Carl M. Halvorson, and I am a general contractor in Portland, Oregon. I appear before the Finance Committee in my capacity as President of the Associated General Contractors of America.

The Associated General Contractors, as our name suggests, is a trade association of construction contractors. We have about 9,000 member firms who come from all fifty of the United States, the District of Columbia, and Puerto Rico. Our business includes all manner of heavy construction; our members build about 75 percent of the contract construction in the United States. I need not dwell at length on the place the construction industry has in the American economy. We are among the most basic of industries. The health of the construction business is essential not only to the contractors of our association and their employees and suppliers, but as well to every economic activity in the Nation.

We appreciate the Committee's courtesy in extending to us the opportunity to express our views on H.R. 13270. This, of course, is one of those periodic occasions when our country re-examines and reassesses its tax policies. The decisions of this Congress will establish national tax policy for many years to come. This consideration, above all else, causes us to view with no small measure of alarm five pending tax proposals, which we believe are poorly founded as a matter of tax policy, inconsistent with a goal of orderly economic growth, and unusually discrimnatory in their cumulative impact upon the business of the members of our association.

Existing Depreciation and Recapture Rules Should be Retained for all Real Estate

Section 521 of H.R. 13270 makes two important changes in the depreciation of real property which are the source of our gravest concern about H.R. 13270. Above all other provisions of this Bill, Section 521 will inhibit the formation of new capital for investment in construction and have a serious recessive effect upon the economy.

The first change would deny accelerated depreciation to used property and restrict depreciation on new nonresidential property to the 150 percent declining balance method. The double declining balance and the sum of the years-digits methods would be forbidden. In addition, the Bill would require that all accelerated depreciation taken on all buildings after July 24, 1969, be converted to ordinary income when the building is sold. These changes do not constitute rational tax policy and do not respond to the supposed evils that are cited in their support.

The proposals are premised on the abuses which can occur upon the use of accelerated depreciation followed by rapid resale of real property. We all know that this combination presents an opportunity for the deferral of ordinary income and its conversion to capital gains. Such tax avoidance devices were becoming common at the time Section 1250 was added to the Internal Revenue Code in 1964 for the purpose of restricting capital gains treatment of accelerated depreciation to owners who held property for a reasonably long period of time. The general approach to Section 1250 is a rational and fair one and we did not oppose its enactment. But we believe the present proposal suffers from a host of defects.

First, it is economically unsound to conclude that only straight-line depreciation reflects economic wastage. The greatest risk of loss and the greatest physical deterioration occur in the early years of ownership. The initial owner—the person who puts up the capital to construct a facility—takes these risks. At no time since the adoption of accelerated depreciation methods in 1954 has anyone produced persuasive evidence to indicate that this is not so or that double declining balance and sum of the years-digits overstate the economic wastage inherent in these initial risks.

Histroically, two factors have been relied on by those who nevertheless argue for elimination of these methods. First, they point to resale prices, which generally exceed adjusted basis. Second, they point to the existence of cash flow in excess of the amount needed to service the mortgage. Although both premises are repeated in the House report, each is fallacious.

Comparison of resale prices to adjusted basis fails to take account of inflationary pressures on real property values. Enormous increases in costs of land, labor, and materials have inflated property values even beyond the general rate of inflation. This is reflected in the report which the Bureau of the Census issued this month entitled "Value of New Construction Put in Place."[1] That report, in evaluating recent construction in terms of 1957–1959 dollars, shows an inflation of over 40 percent in the last ten years. Construction costs have increased by 30 percent since 1964 and at least 15 percent just since January 1968.[2] Thus, a building built in 1964 should have increased in value by at least 30 percent to keep pace with the inflation in building costs. The squeeze on urban land should increase the value even more.

It is, therefore, not surprising that resale price often exceeds adjusted basis. But this only proves the great inflation we have suffered in the last five years. It does not show that accelerated depreciation methods are now overly generous. Rather the increases in property value are true capital gain because they represent a true increase in the dollar value of the invested capital, an increase caused by the combination of inflationary pressures and the growing scarcity of land.

Insofar as the excess of cash flow is concerned, the first critical point is that the tighter money becomes, the smaller that excess is. The second point ignored in the House is the need of a cash reserve for repairs and maintenance. The creation of such a reserve is the prime economic function of depreciation, and, in a soundly managed operation, the reserve is constantly being used for renewal of the property.

My next point is that the real estate provisions of this Bill are not responsive to the abuses its sponsors claim to perceive. Rapid turnover is the key to any tax abuses which exist. The feared deferral and conversion of ordinary income occurs only if the property owner holds real estate for a short period of time and resells it without making the repairs necessary to account for the physical deterioration occurring during his ownership. This abuse is most readily achieved and most commonly occurs in residential property. For purposes of national policy with which we agree—to encourage the badly needed expansion of the housing supply—H.R. 13270 exempts residential structures from the proposed restrictions on accelerated depreciation. The tax consequence, however, is that the double declining and sum of the years-digits depreciation would continue to be available in the area that is most susceptible to abuse and would be denied only to industrial and commercial structures, where rapid turnover is not as likely and long-time ownership is the rule.

Oddly enough, this treatment is exactly the opposite of that provided in Section 221 of the Bill, which limits the deduction of interest on loans used to carry investment assets. Section 221 directly recognizes that expenses incurred in a trade or business do not lend themselves readily to abuse, and interest paid in the conduct of a trade or business is exempted from the limitations established in Section 221.

The same approach should be applied to real estate. Industrial and commercial facilities do not invite turnover and do not allow postponement of repairs in the manner of residential housing. They are simply not the proper target for restrictions on accelerated depreciation.

The restrictions of Section 521 would also increase the competitive disadvantage American business experiences in foreign markets. Tax structures abroad place high priority on the rapid recovery of capital investment, even allowing depreciation writeoffs substantially in excess of economic wastage. America must compete for the construction budgets of domestic and foreign industries, and the inevitable result of Section 521 would be to encourage domestic capital to go abroad, and foreign capital to remain beyond our boundaries.

These factors all show the unreason of restricting the depreciation available to industrial and commercial facilities. Since there are other sound reasons for

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[1] Construction Reports, Value of New Construction Put in Place July 1969 (issued September 1969), United States Department of Commerce Publication C30–69–7.

[2] See Tables 2, 3, and 18 of Publication C30–69–7.

not applying this part of Section 521 to residential housing, it simply should not be enacted.

The recapture provisions of Section 521 are equally unjustified. This part of the Bill and the existing provisions of Section 1250 of the Internal Revenue Code are both intended to inhibit the rapid turnover that facilitates the use of accelerated depreciation to convert ordinary income into capital gains. Here, however, the similarity ends. While Section 1250 uses the carefully designed method of measuring the recapture of depreciation into ordinary income by the length of the taxpayer's holding period, Section 521 would recapture all accelerated depreciation, whatever the length of the taxpayer's holding period.

The hearings and the reports are entirely devoid of any justification for this change. There is no demonstration that Section 1250 has worked badly and there is no reason to believe that it has. Surely, Section 1250 should be left as it is until there is acceptable evidence that the statute still leaves room for abuse.

But if the rules are to be changed, the basic structure of Section 1250 is the only one consistent with sound tax policy. All should agree, I believe, that the man who holds real property for ten years is not the source of tax abuse. The problem is to determine the minimum holding period necessary to deter avoidance. We believe that the twenty month minimum now established in Section 1250(a)(2) is long enough, since the section retains a prorated recapture for holding periods between twenty months and ten years. If the Congress concludes, however, that abuse still exists, it would not be a fair or rational solution to penalize the bona fide long term investor as H.R. 13270 would. The proper response would be to extend the minimum holding period, while adjusting the rate of recapture[3] to retain ten years as the holding period when recapture ceases to apply.[4]

The Need for Reform of Capital Recovery Rules

We recognize that today is not the appropriate time to present testimony relating to the proposed repeal of the investment credit. I must, however, start with that as background, for heavy machinery is one of the major costs in our industry, and repeal of the investment credit without adoption of long needed reforms or our capital recovery system will impose a substantial and unwarranted tax increase upon our industry.

Most of our machinery and tools are now treated as having a five year useful life. Superficially this appears to be generous. When viewed against the demands of the construction business, however, this rule, which revenue agents refuse to vary on audit, ignores the actual shorter useful lives of our equipment and therefore artifically exaggerates the true income of the construction business.

The purchase price of construction equipment is high, yet its useful life is relatively low. It is worked hard and it is worked out of doors under widely varying conditions. The life of this equipment is shortened by differences in the competence of operators, the unavailability of proper maintenance in this field, and the inherent difficulty of excavation and other aspects of construction work. For any one contractor, the useful life of his equipment varies with the type of work he does and the abilities of the men in his employ. The same machine may be useless after six months on one kind of job, but have a life of several years in other work. Our continuing need to find and accept technological change further quickens the obsolescence of our tools and equipment. And to compound these difficulties, many members of our association are called upon to do specialty and nonrecurring work which requires equipment that is useful only to that contractor and only on that job.

The end result is a great need for depreciation rules realistic enough to accommodate the unusual circumstances of our industry. The five year useful life now generally applied to us[5] is not a reasonable expectation for the average

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[3] If, for example, the minimum holding period were extended to 36 months, 1.2 percent per additional month of ownership would then represent an appropriate adjustment to recapture.

[4] In addition to these difficulties, the recapture provision of the new Bill is most inequitable. Real estate is a relatively risky and nonliquid investment. Persons placing money in real estate must plan for a relatively long period. The amount of depreciation available and the presence or absence of recapture is one of the determinants that influences the investment decision. This Bill changes the rules in mid-stream for all existing or committed real estate, since the recapture rules apply to depreciation attributable to periods after July 24, 1969, regardless of the acquisition date.

[5] The far longer 12-year life applied to equipment designed for maritime construction constitutes an extreme imposition upon the economics of the construction industry. In addition to all the problems of land-based construction, maritime equipment is exposed to unusually inhospitable and corrosive working conditions. It should have no longer a depreciative life than land equipment, and often should be depreciated over its use in a particular job.

piece of construction machinery. The use of this life has denied us deductions that reflect true costs of operation. The investment credit has helped compensate for this defect, so long as it has existed. If the Congress now allows the administration to withdraw from the repeated assurances that the investment credit could be a permanent part of our tax structure, then it is essential that the Congress at the same time provide a general overhaul of our capital recovery structure.

I emphasize that we do not seek specific relief for the construction industry. Rather, we see our problem as one facet of a general pattern of unrealistic tax depreciation rules which repeal of the investment credit will impose on business. We believe that the adjustments to the rules for our industry would be part of a general reform of the capital recovery structure.

That reform should begin with recognition of three essentials of any rational capital recovery policy.

First, depreciation lives must be based on the best practice which recognizes the problems inherent in each taxpayer's business. Whatever average lives are used as benchmarks must account for and depend upon the best practice for the industry. A technological revolution is fully upon us, in an unprecedented sweep. In construction and every other business, scientific invention speeds progress beyond prediction; equipment becomes obsolete and requires replacement with amazing frequency. Unless depreciation lives are consistent with optimal replacement practices which keep pace with technology, the tax code will build obsolescence into American industry. Here again, American business would be disadvantaged in foreign competition. American firms seek contruction jobs abroad; success benefits the American economy, while diminishing balance of payment and gold flow problems. The principal foreign industrial nations, as a foremost matter of tax policy, provide depreciation methods designed to give the maximum possible incentive to renewal of capital equipment. We cannot compete meaningfully abroad unless depreciation reform in the United States eliminates our continual lag behind the practices of other countries and provides us with the cash flow necessary to maintain a competitive technology.

Second, depreciation reform must recognize that some taxpayers must replace equipment even more rapidly than the industry optimum. This is particularly so of the construction business. Up to the early 1960's, the construction industry, more than any other, suffered continual harrassment from Internal Revenue agents who refused to recognize the depreciation problems of individual contractors. Now that the moratorium on the application of the reserve ratio test has ended, we have every reason to expect a renewal of hostility on the part of auditing agents. The need for a realistic approach on audit will be even greater if the investment credit is lost, yet repeal of the credit may well serve to encourage the Internal Revenue Service to return to practices that for thirty years inhibited capital investment. Depreciation reform must therefore reiterate that the special problems of individual taxpayers must be recognized; a businessman's reasonable decision of how to manage his own business should be given the strongest weight.

Third, changes in depreciation lives must not be viewed as a revenue gathering or contracyclical device. Ever since Bulletin F was adopted during the Great Depression, the tax collector has been tempted to raise more money by lengthening useful lives. This very thought was suggested this year as one of the reasons for changing the rules for real estate depreciation. This approach runs counter to every basic of rational tax policy. As a matter of economic policy, it invites disaster. The question is one of confidence. Orderly economic growth requires a climate for orderly capital investment. The planning which must underlie rational investment is impossible if depreciation rules are hostage to unpredictable change. Only meaningful depreciation reform, in a context which provides permanance of structure, can restore the confidence shaken by a retraction of the assurances that the investment credit was here to stay.

The specifics of depreciation reform should start with the proposals offered to this Committee on September 11 on behalf of trade associations representing the machine tool industries. Two of the proposals, elimination of the reserve ratio test and the amendment of Section 167 to eliminate the need to establish salvage values, would simplify tax accounting and eliminate endless controversies of no lasting significance with revenue agents. The elimination of salvage values is particularly essential to our members, for the economic fact of life is that these values are generally nil in the construction business, and for many of our items there is no predictable or readily available salvage market.

We also agree that the guideline depreciation lives of equipment should be codified, but with recognition of the economic realities of the construction business. Three years rather than five years should be established as a realistic life for construction equipment, and the codification should expressly allow for those instances where the practices of particular taxpayers require shorter lives.

The fourth proposal was that Section 179 be amended to eliminate the $10,000 ceiling upon the additional first year depreciation allowance, with a possible reduction in the rate of that allowance from 20 percent to 15 percent. Such a change would be particularly equitable if applied to the construction business. Therefore, we urge that Section 179(d)(1) be amended to allow the application of the provision to depreciable property without regard to its useful life. As short lived as our equipment is, the greatest amount of wear and tear occurs in the first year of use. A great amount of the equipment is virtually useless and unsalable at the end of the first year. Such an amendment would help compensate for the loss of cash flow that would follow repeal of the investment credit, cash that is necessary to enable us to keep our tools and equipment modern and usable.

Interest on the Obligations of State and Local Governments Should Remain Tax Exempt

A significant portion of the business of members of our association consists of public construction. That construction depends on the existence of regular and orderly financial markets where local governments may market their securities. The experience of the money markets over the last several months demonstrates that unfortunate portents for public finance inhere in the inclusion of interest on the obligations of state and local governments within the definition of tax preference items in Section 301 of H.R. 13270.

We do not disagree with the basic purpose of Section 301—to require each American to pay some tax on his economic income. We dispute, however, the inclusion of interest on state and local obligations as an item that does not bear a fair share of the national tax burden.

As a formal matter, the holder of these obligations pays no tax on his interest income. As a consequence of the present tax exemption, however, the holder receives a lower yield. In substance, he pays a silent tax measured by the difference between the interest he receives and the greater interest available from securities not enjoying an exemption.

In addition, unlike the other items included in the definition of tax preference, this is not a situation where the elimination of one man's exemption will decrease his fellow citizens' taxes. The obvious and expected effect of the proposed legislation will be a significant increase in the yields on state and local obligations. That increase must be satisfied through increases in the taxes imposed by the issuer of the obligation. And it is not realistic to expect that the Federal taxes paid by purchasers of these obligations will exceed the additional burdens being placed on state and local taxpayers. It is more likely that high bracket taxpayers will take their money out of state and local securities and place them either in other tax exempts or in situations that offer a potential for capital gains. This is already being demonstrated, for nearly every day the financial press reports instances of the difficulties state and local governments have been having in borrowing funds since the House passed H.R. 13270. Thus, this is a so-called "reform" that will increase everyone's taxes, and decrease no one's, achieving all this while diminishing the ability of state and local government to provide needed facilities and services.

The Existing 5 Percent Depletion Rate For Sand and Gravel Should Not Be Reduced

The proposed 20 percent reduction in depletion on sand and gravel is the fourth aspect of H.R. 13270 of concern to the construction industry. Sand and gravel now have the smallest depletion rate in the tax code: 5 percent. In contrast to most minerals, depletion rules provide sand and gravel with a less favorable method of capital recovery than would be available if the ordinary capital gains treatment were available. Nevertheless, Section 501(a) of the House Bill would reduce this modest depletion rate to 4 percent.

The House Report focuses on petroleum. It fails to offer a single word of explanation or justification for changing the rate for sand and gravel. This smallest of depletion rates seems to be a victim—perhaps an unintended victim—of the emotions stirred by oil and gas depletion rates.

We in the construction industry are the primary consumers of sand and gravel. It is a basic construction commodity. The demands for it are enormous. Production now exceeds 900 million tons annually. As large as that is, the United States

Bureau of Mines, in a study entitled "Cumulative Demand Projections For Sand and Gravel," projects a demand during the last thirty years of the twentieth century "in the range from 57.2 to 65.6 billion tons." This means that the annual output of sand and gravel must be doubled during the last third of this century, even though a study conducted in 1963 showed a life expectancy for reserves of only 24 years.

In consequence, sand and gravel producers face a staggering need to find and develop new supplies between now and the year 2000. Furthermore, the high costs of transporting this material requires that deposits be developed near metropolitan areas; this in turn adds further to the cost, for the proximity of the site to urban areas requires extensive cost for site rehabilitation after the sand and gravel is removed.

This, I submit, constitutes the strongest of cases for not lowering the already low depletion rate for sand and gravel. The proposed reduction in rate can only increase the cost of sand and gravel and thereby increase the cost of construction. The construction industry is already suffering from a rate of inflation far higher than the national average. Here H.R. 13270 would add to that inflation without the slightest justification in tax policy or economics.

The "Country-by-Country" Limitation on Foreign Tax Credit Should Not Be Changed

Section 431 of H.R. 13270 would impose an additional burden on United States contractors who seek to do business abroad by imposing new restrictions on the "country-by-country" foreign tax credit. The hardship would be particularly severe for the contractor least able to bear it—the one doing his initial work overseas or who has a limited amount of overseas work in only a few countries. He is the one who normally uses the country-by-country limitation, since he lacks the large base of foreign income available to companies with more developed business throughout the world. The effect, moreover, would be particularly magnified in its influence on the balance of payments, for these are the same businessmen who most tend to repatriate investment and profit.

The asserted justification for the proposed changes is that a United States' taxpayer with losses in a foreign country may receive a double tax benefit if, in the year of the foreign loss, he offsets it against domestic income, and then in a better year takes a credit for foreign taxes. This danger, however, is mostly theoretical, and where the danger is real, the effect of H.R. 13270 would be to impose a form of double taxation on American businesses doing business abroad.

The asserted double benefit cannot be realized in respect of activities in countries which provide for loss carryovers in their tax laws, since the taxpayer sets off losses before taxes become due to the foreign authority. The problem can only arise in those countries, usually undeveloped, which do not allow loss carryovers in their tax laws. The result in those cases is an increased effective tax rate in profitable years. The existing United States law allows a taxpayer to mitigate the impact of this increased effective rate by the use of foreign tax credits. This well serves the function of foreign tax credits—to allow United States business to conduct international trade in a climate where the combined foreign and domestic tax burden does not exceed the United States rate. Because the proposed change in the country-by-country credit would apply only where the foreign country imposes an increased effective rate, H.R. 13270 would create a form of double taxation by imposing a total tax burden in excess of the United States rate.

We strongly urge that this limitation be deleted because its impact will be on smaller business and the result will be a deterioration of the American position in foreign markets. If it remains, however, it should be amended so that the United States "recapture" will not bring the total foreign and United States taxes above what the United States taxes would have been if the foreign operations in all the years in issue had been carried on in the United States.

H.R. 13270 Would Subject the Construction Industry to a Multiplicity of Recessive Yet Inflationary Pressures

To this point in my presentation, I have focused on specific aspects of H.R. 13270. Now I should like to view them from the perspective of the Bill's overall impact on basic construction.

The changes in rules for depreciation and the changes in the tax exempt status of interest on state and local obligations will serve to decrease the amount of new construction. At the same time both changes will increase the costs to users of new property. The repeal of the investment credit without compensating depreciation reforms and the reduction in depletion on sand and gravel will directly increase our costs. The Bill also would impose new and serious impediments to the investment of foreign capital in the United States and to the ability of American businesses to compete in foreign markets. Tight money and construction cutbacks have yet an additional negative impact on our industry.

The Bill then has the recessive effect of inhibiting construction while at the same time adding to inflationary pressures. Each of these aspects of the Bill feeds upon and re-enforces the other, and they are further multiplied by the other contracyclical measures the Administration has taken. Although H.R. 13270 is called a tax reform bill, the features I have discussed here simply cannot be justified as attacks on demonstrated abuses. They are poorly conceived, dangerous to the American economy, and should not survive the scrutiny of the Senate.

The CHAIRMAN. The next witness is Mr. Leon H. Keyserling speaking for the Realty Committee on Taxation.

We are happy to welcome you back here, Mr. Keyserling. You have been gone altogether too long. I am always pleased to hear your views on matters that have to do with economics, taxation, and national growth.

STATEMENT OF LEON H. KEYSERLING,[1] APPEARING FOR REALTY COMMITTEE ON TAXATION AND AS INDEPENDENT ECONOMIST

Mr. KEYSERLING. Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, the provisions of the bill relating to the housing and other real estate are inseparably related to the provisions of the bill as a whole, which must be viewed in the perspective of general economic and financial considerations. Thus, I appear here only in part on behalf of the Realty Committee on Taxation, and more basically as an independent economist concerned with the public interest.

Many provisions of the bill are good, but I concentrate on those needing repair. Those needing repair bear the same defects as, and would aggravate the current consequences of, the errors in the massive tax cuts of 1963–65, and especially 1964, which I opposed on grounds vindicated by time.

Like its forerunners, the current bill overstimulates heavy investment, at the expense of consumption, and thus augments the main source of rampant current inflation combined with inadequate real economic growth. Its personal tax cuts are highly inequitable, especially in view of those in 1964. It hands out bonanzas to some types of industries and investment requiring restraint, but cruelly discriminates against housing and supportive aspects of urban commercial contruction, despite universal consent that urban rescue and renewal is our most critical domestic priority. It would thus add greatly to unemployment. In the very name of reform, it violates the justice which is the essence of reform. It is pennywise and pound foolish, with respect to recapture of federal revenues.

Specifically: excluding the reforms—I believe analysis of the bill excluding the reforms extremely important for various reasons which I shall state shortly, although I, of course, favor those reforms directed toward more equity in the tax structure—the House bill, by some of its provisions, cancels out the effect of repeal of the 7-percent investment tax credit, and the Treasury proposal increases net stimulus to inflationary investment by $1.1 billion. Even with the reforms,

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not even the House bill tightens up enough on inflationary and postponable types of investment. I favor a tightening up on the net allocation to investment as affected by tax policy by about $6 billion. This would leave much more room for correcting the unwise and untimely provisions bearing down upon investment in housing and also nonresidential construction, and also for the further equitable changes in the tax structure to which I shall refer.

As to the personal tax cut inequities: Without the reforms, neither the House bill nor the Treasury proposal gives more than 20.8 percent of the personal tax cuts to those with incomes up to $5,000 who constitute 47 percent of total returns, while they give 13.4–17.2 percent to those with incomes of over $50,000 who constitute only 0.4 percent of all tax returns. (The housing provisions further discriminate against those in need of better housing at lower costs, and thus would hurt their incomes still more. This shows the seamless-web connection between the various provisions of the bill.) The other distributions, between the two extremes cited, are similarly inequitable. The provisions without reforms are, as I have said, extremely important, because the reforms are more uncertain of enactment; they do not impact equally upon all those even within the same income group; and we know from experience that, if the reforms are modified or mutilated, the regular rates do not tend to be adjusted accordingly. They certainly weren't in 1964. But, even with the reforms, the distribution of the cuts is highly inequitable.

By the most meaningful test, effect upon after-tax or disposable income, the House bill, with or without the reforms, increases such income by less for those with incomes from $5,000 to $20,000 than for those with incomes from $20,000 to $50,000; and, without the reforms, increases disposable income by immensely more for those over $50,000 than for any other group. The Treasury proposal is far more regressive. Even with the reforms, both the House bill and the Treasury proposals are not nearly progressive enough. In this connection, taking all forms of nationwide taxation into account, those with incomes between $3,000 and $4,000 pay a higher share of their incomes in total taxes of all kinds than any other group up to $15,000, and almost as high a share as those with incomes between $15,000 and $20,000.

I suggest no change in personal tax payments, before or after reforms, for those with incomes of $50,000 and over, and I seriously question substantial, or perhaps even any, such reductions for those with incomes of $20,000 and over. This approach would leave that much more for net tax reductions for those lower down in the income structure.

The CHAIRMAN. Mr. Keyserling, I would suggest you read it a little more slowly if you are so disposed. With all the background you have has as Chairman of the Council of Economic Advisers, I am not going to cut you off at 10 minutes.

Mr. KEYSERLING. I think I will get through in 10 minutes, but thank you very much, Mr. Chairman, for your consideration.

Coming to the provisions relating to housing and nonresidential commercial investment, let me here emphasize, since the Chairman has been so gracious with me as to time allowance, that economists in general, the Council of Economic Advisers in particular, businessmen, and even sometimes the Congress, look at the provisions of a tax bill without sufficiently relating one provision to the other, and without relating the provisions of the bill to the general economy and to our economic and social objectives as a nation and a people. But all of these factors interrelate. What is done with respect to the taxation of low income people through tax cuts interacts with what is done to them with respect to housing. This is because the cost at which they can get housing affects their incomes available for all these other purposes. This bill, in its current from, has the multiple impact of being inequitable in what it does to them on its straight tax reduction provisions, and also in what it does to them with respect to the investment provisions of an ad hoc nature which bear upon housing and supportive nonresidential construction investment (as against the bills treatment of other investment).

Now, another ironical thing which I want to reemphasize for the benefit of some of the Senators who were not here when I started—that is off the record.

Senator WILLIAMS. We will read it, we can't hear all of it.

Mr. KEYSERLING. What is that?

Senator WILLIAMS. I say we will read it because we can't hear all of them. We get the same thing over and over.

Mr. KEYSERLING. But anyway, to reemphasize what I said earlier, everybody is saying we want to get the reforms, and we don't want the bill without the reforms. But the repeal of the 7-percent investment credit by itself is more of a reform than that repeal together with some other parts of the bill. This is because these other parts would give back to the same people who would be hit properly by the repeal of the 7-percent investment credit more than that repeal would take away from them. This, in itself, would repeat the errors which I protested against in earlier years, despite the fact that the main source of the current inflation is the 13-percent annual rate of growth in the very type of investment which is the most inflationary thing in the whole economy. We are trying to stop this by the 7-percent investment credit repeal, and that is fine.

But when one looks at the bill as a whole, it does not do what the public thinks it is trying to do.

Now, I say we should tighten up much more than the bill does on these types of soaring and overebullient investment, instead of tightening up on housing and supportive nonresidential commercial investment, which are falling dangerously short of meeting our nationwide needs.

The provisions of the bill relating to housing and nonresidential commercial investment are the best single example of starving the lean while other provisions feed the fat. The widespread impression that the bill draws a sharp dichotomy between housing and nonresidential commercial construction investment is entirely erroneous. The preponderance of the provisions of the bill inimical to real estate generally are also highly inimical to housing. In any event, urban rescue and renewal do not depend upon housing alone, and I think I have been sufficiently partial to housing for a long time, and still am.

Housing, especially for the poor and others of low income who cannot move out of cities, is intimately associated with and supported by commercial structures—stores, community and recreational facilities, and professional space. These are even sometimes in the same project as housing, built by the same people. And if they were both built by more of the same large-scale people, we would have a better chance of moving forward on the rescue and renewal of our urban areas at the tremendous pace which is imperative on all grounds.

Vastly accelerated investment along these lines can provide vast expansion of employment, to serve vital national needs in the years ahead, and to counteract technological displacement in other key sectors. Such programs and projects are essentially long range, and we cannot afford to stunt them further now, even if (contrary to my conviction) stunting them now would be anti-inflationary. It would really be inflationary by aggravating critical current shortages and thus driving up rents still further.

Here we have a bill which really, on the investment side, operates almost exclusively against housing and supportive nonresidential commercial investment. Meanwhile, what are the facts? Private nonfarm housing starts declined, on a seasonally adjusted annual basis, from 1,845,000 units in January 1969 to 1,314,000 units in July, or 28.8 percent, and the ênd if not yet. The ratio of housing and commercial construction investment (combined) to GNP declined from 7.13 percent in 1950 to 4.39 percent in the second quarter of 1969; and the decline in this ratio has been almost constant. As a percentage of gross domestic investment, the decline was from 40.8 percent in 1954 to 29 percent in the second quarter of 1969. During 1961–68, measured in uniform dollars, the average annual growth rate of investment in commercial construction was only 4.9 percent, and in housing only 0.5 percent. This occurred during a 7-year period when we all talked about doubling this rate of housing starts, and enacting legislation toward that end. Meanwhile, during the same period 1961–68, the average annual rate of growth in real terms was 5.2 percent for GNP, and 9.9 percent for investment in producers' durable equipment, the latter of which this bill would further stimulate, as I have said.

In vivid contrast with the trends just cited, balanced goals for the whole U.S. economy require an annual average growth rate through 1977 of 5.9 percent for commercial structures, and 11.2 percent for residential structures, compared with 5.3 percent for GNP, and 4.1 percent in producers' durable equipment.

These are not just my goals. These are the goals, of course with some variations, embodied also in the housing programs of the Government as legislated by the Congress; they are the goals embodied in the studies of other economists. So, while we are all doing other things to try to get housing growing faster than the rest of the economy, we are, through this bill, discriminating against it and supportive nonresidential commercial construction, in the face of the gross disparities in what has actually been happening, and is still happening with a vengeance.

Real estate has been faring worse, by various financial tests, than any of seven other basic industries which I have analyzed. Viewing net income as percentage of new worth, the figure in 1965 for real estate was 3.5 percent, compared with 6 percent for finance and insurance, 10.3 percent for manufacturing, and 8.2 percent for all industries. In real estate, long term debt comes to almost 50 percent of total assets, compared with 12.2 percent for all industries. Since 1951, rising interest rates alone have imposed an excess cost aggregating more than $17 billion in connection with mortgages on one to four family homes alone. The rising interest burden, and I underscore this, the rising interest burden has already imposed upon housing and supportive nonresidential commercial investment a toll which has exceeded many, many times the total benefits flowing to these sectors through all types of Federal tax concessions.

Now, I come to Federal costs. In terms of Federal costs, the vital areas needing the most help have been given the least, and, in the main, vice versa. In 1966 (I have no later comprehensive data from official sources), of the $43.1 billion value of depreciation and depletion allowances, 45.7 percent went to manufacturing, and only 5.8 percent to real estate. During the fiscal years 1964–69, viewing more than $6.7 billion of average annual net expenditures for Federal subsidy programs, 57.9 percent were going to agriculture, 10.5 percent to air transportation, and only 2.9 percent to housing. It follows with certainty that any recoupment of Federal revenues which could result from further tightening up on the tax treatment of housing and nonresidential commercial investment would be a mere bagatelle, compared with the potentials for recoupment along beneficial rather than damaging lines, when measured in terms of economic activity and human well-being. What has already happened to housing alone since January 1969 (the 500,000 reduction in the annual rate of housing starts, and the bill would make this worse), implies on an annual basis a loss of $3.8 billion in Federal revenues at existing tax rates, $109 million in State and local property taxes, and involves 1.7 million man-year jobs.

My full statement analyzes in detail the relevant sections of the bill. Briefly, the provisions which would be damaging to both housing and nonresidential construction investment include substitution, in the case of used buildings, of straight-line depreciation for the presently allowable 150-percent declining balance method; the recapture provisions; the treatment of "excess" depreciation under LTP and allocation of deductions; the limitation on interest deductions; the "additional preference" Treasury proposal; and certain retroactive features of the bill. Applicable to new nonresidential structures but not to housing (and I stress that the other provisions I have mentioned are applicable to housing, although a lot of people believe this bill lets housing off), there is also the undesirable substitution of 150-percent declining balance method for the double declining balance method.

I respectfully submit that we should be considering methods to accelerate housing and nonresidential commercial investment, instead of adding to its present plight. And insofar as the overall economy is now deemed to be too tight to ward off excessive inflationary pressures (my full testimony sets forth why I believe this to involve a mistaken diagnosis as to the causes of recent and current inflation), we should further tighten up on those other sectors where the national interest so permits, and there are many of these.

As to the entirely laudable desire for reform, I read an article in Reader's Digest this week, by a former Internal Revenue Commissioner, purporting to reveal the horrible advantages that some people take by means of accelerated depreciation on housing and other real estate. I am against these misdeeds just as much as is, and my entire record proves this. But the provisions of the bill which are designed to catch those individuals or business entities who are getting away with too much in some industries, by delimiting some special tax incentives, do not apply the same method to those in other industries who are generally or even to a greater degree getting away with something. I am talking now about the glaring cases. This distinction is made by the bill, apparently on the ground that such other industries need further stimulation. But even if some of these other industries require further stimulation, that is no justification for anyone getting away with something in such industries. So if we are trying to catch those who are taking advantage of a tax provision, they shouldn't get away with this, if they happen to be in the airline industry or in the trucking industry, any more than in the housing industry, or in nonresidential commercial investment. Yet these provisions to catch those who are getting away with something is focused upon these two last-mentioned sectors predominantly.

The appropriate method to catch the recreants, in other words, those reducing their taxes too much, or to zero, is by limiting total allowable deductions, so as to permit none to pay too small a percentage of their incomes, or zero percentage, in taxes. The provisions toward this end should be further strengthened. But enlargement or contraction of special or ad hoc tax incentives should relate to the condition of each particular industry as a whole, and its relationship to national needs. The treatment of housing and nonresidential commercial investment does not do this, and I earnestly hope that this committee will help to correct this dangerous imbalance.

I request that my full testimony with charts, and my prepared summary thereof as earlier submitted, be inserted in the record at an appropriate point.

The CHAIRMAN. Mr. Keyserling, your statement in the record here is about 110 pages long. I want to promise you that over the weekend I am going to study everything you have said here plus these charts. I regard you as one of the best economic advisers in this Nation by any standard, and what you have said here certainly deserves the utmost of consideration. As far as I am concerned I will give it every bit of study. I think I generally agree with your conclusion that where someone—because of something we put in the law for a worthwhile purpose—achieves some kind of advantage by taking advantage of several deductions or maybe a dozen different deductions in the law and pays very little taxes, we ought to go back and tax him on a different basis. But that need not necessarily serve to totally eliminate something that is in the law for a good reason.

Mr. KEYSERLING. Mr. Chairman, let me just give you some examples of why this is sound. All national tax policy deals with the general situation, and must. Any major sector of tax policy which is liberal enough to do the job it is intended to do will be too lenient for a few, and if we make it tight enough to catch those few, it will cut off the head of others who need to be encouraged or helped. We must consider the greatest good of the greatest number.

Let us look for a moment at the old age insurance system. Now, part of that is paid for by the Government, that is, paid for by the general public. Yet nobody says that is unfair that people get their benefits, including the part paid for by the Government, because they may have assets of a million dollars, or $10 million. If we wanted to become particular as to them, we wouldn't give these benefits to them. But we want a generalized system, and we try to catch them under other sectors of the tax laws. It is true of almost any other tax provisions of any kind, including personal and corporate income taxes, special tax concessions, et cetera, that the provisions best designed for overall purposes work unfairly in some glaring cases. But I view it to be pure sensationalism to let the tail of these glaring cases swing the elephant. Limitation of deductions is the correct remedy.

Yet, what is proposed in the bill, because of these few glaring cases, is to further jeopardize an entire industry, although on net balance the existing special incentives to this industry are the most beneficial, and in fact, to date among the very few ad hoc special tax concession provisions which are genuinely desirable in terms of the national interest.

The CHAIRMAN. Thank you very much, Mr. Keyserling.

Mr. KEYSERLING. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. I was going by the Miller modification of the Long motion.

(Mr. Keyserling's prepared statement follows:)

STATEMENT OF LEON H. KEYSERLING* IN PART REPRESENTING REALTY COMMITTEE ON TAXATION AND IN PART AS INDEPENDENT ECONOMIST

SUMMARY

Mr. Chairman and Members of the Committee:

General considerations

I appreciate this opportunity to add to your consideration of one of the most momentous economic and financial measure in many a year. The Bill in its present form contains many essential and desirable provisions. But I shall concentrate upon what I regard to be the need for improvement, as that should be most constructive and helpful to this Committee. Clearly implied in these comments will be my attitude toward those provisions which appear to me to be sound and good.

The major portion of my testimony relates to general economic and financial considerations and their bearing upon the general provisions of the Bill, because I am profoundly convinced that we all tend to pay too little attention to these ultimate matters when considering tax proposals. In these phases, I appear independently, as I have so many times previously before this Committee. My specialized comments bearing upon the provisions of the Bill dealing with housing and other real estate investment is made on behalf of the Realty Committee on Taxation, although my conclusions in this area are also arrived at independently, and I hope objectively.

The past is prelude, and my previous testimony before this Committee and elsewhere on the massive tax cuts and concessions of 1962–1965 is highly relevant to the current Bill. I felt in the years gone by that these massive tax cuts and concessions were greviously misdirected in large degree. They surrendered too much Federal revenues, in terms of national and international needs dependent upon public spending; misallocated resources between investment and consumption so as to impair economic equilibrium and work against maximum economic growth, production, and employment; and aggravated inflation and the balance of payments problem by ignoring the real causes thereof. On both economic and social grounds, they helped too much those who needed help least, and helped too little those who needed help most, both on the individual and business entity side.

I submit that the more recent developments have very substantially vindicated my earlier concern. Although inflation is now rampant, our real rate of economic growth since 1966 has been much too low, is much too low now, and this in itself aggravates rather than curbs inflationary pressures, and adds to unemployment. The most urgent of our domestic priorities are being relatively

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neglected. Fiscal policy is still highly contributory to resource misallocation. The current Bill, if properly corrected, affords a tremendous opportunity to use the mighty weapons of fiscal policy to learn by experience, correct the errors of the past, and put us on the right course.

But the Bill in its current form, in very large measure, does not do this. On equitable grounds, it makes a highly improper distribution of tax relief, especially when added to the gross inequities of the 1964 measure in this respect. On economic grounds, it does not go nearly far enough in the direction of redressing the imbalance between investment and consumption. Its specialized or *ad hoc* provisions discriminate against those lines of endeavor which need most to be stimulated greatly, most especially housing and supportive nonresidential construction investment, while dealing lightly or even favorably with lines of endeavor which have been and now are running relatively much to fast.

Misallocation of investment provisions of the bill

Specifically, excluding the tax reforms, the House Bill does not appreciably affect net investment allocations as affected by tax policy, and the Treasury proposal increases them by 1.1 billion dollars. This is ironical, in view of the proposal to repeal the investment tax credit on the ground that investment in general is grossly excessive. Even with the reforms, the House Bill reduces the allocation to investment as affected by tax policy by only 3.9 billion dollars, and the Treasury proposal by only 2.5 billion. This is not nearly enough. I favor a tightening up on the net allocation to investment as affected by tax policy by about 6 billion dollars, which woud leave much more room for reconsideration and revision of some of the provisions bearing down upon the tightening up of investment upon housing and also nonresidential construction, for reasons which I shall subsequenty disclose.

Inequitable features of personal tax cut provisions

The inequitable features of the current Bill, also highly undesirable from the functional economic viewpoint, are as follows: Without the reforms, neither the House Bill nor the Treasury proposal gives more than 20.8 percent of the personal tax cuts to those with incomes up to $5,000 who constitute 47.0 percent of total returns, while they give 13.4–17.2 percent to those with incomes of over $50,000 who constitute only 0.4 percent of all tax returns. The distributions between these two extremes are subject to the same type of inequity, I believe that the provisions viewed without reforms are more important than those viewed with reforms. The reforms are more debatable and uncertain of enactment; they do not impact equally upon all those in any given group; and we know from experience that, if the reforms are modified or mutilated, the regular rates do not tend to be adjusted accordingly. But even with the reforms, the distribution of the tax cuts is highly inequitable.

And by the far more meaningful test of effect upon after-tax or disposable income, the House Bill with or without the reforms increases such income by less for those from $5,000 to $20,000 than for those with incomes from $20,000 to $50,000. Without the reforms, the House Bill increases disposable income by immensely more for those over $50,000 than for any other group. The Treasury proposal is far more regressive in these respects. Even with the reforms, by this vital test, both the House Bill and the Treasury proposals are not nearly progressive enough, especially in view of the imperative need to counteract in part the highly regressive features of the 1964 tax cuts. This imperative need is best illustrated by the fact that, taking all forms of nationwide taxation into account, those with incomes between $3,000 and $4,000 pay a higher share of their incomes in total taxes of all kinds than any other group up to $15,000, and almost as high a share as those with incomes between $15,000 and $20,000. Those still higher up, by all equitable tests of progressivity, do not pay a sufficiently higher proportion of their incomes in taxes of all types.

All things considered, I suggest not reducing at all the personal tax rates, before reforms, of those with incomes of $50,000 and over, and I seriously question whether there should be substantial, or perhaps even any, such reductions for those at $20,000 and over.

The amounts thus saved should be used for further reductions for those lower down in the income structure, with emphasis on progressivity.

General comments on defects in provisions relating to housing and nonresidential construction investment

The extent to which the foregoing provisions of the Bill depart from desirable allocations of tax changes, both on economic and social grounds, are paralleled by comparable departures with respect to the more specific or *ad hoc* features of the Bill, especially those bearing upon housing and what I regard to be the intimately associated factor of investment in nonresidential construction. And because our economy and the problems of our people are a seamless web (and so is fiscal policy), the generalized and specialized departures from desirable tax changes have mutual and cumulative effects.

The widespread impression that the Bill draws a sharp dichotomy between housing and nonresidential commercial construction investment is erroneous. As I shall disclose, the preponderance of the provisions of the Bill inimical to real estate generally are aso inimical to housing.

Even more important, we are here again dealing with a seamless web. Urban rescue and renewal do not depend upon housing alone. Housing, especially for the poor and others of low income who cannot move out of cities, is intimately associated with and supported by commercial structures—stores, community and recreational facilities, and professional space. And investment in all of these can provide vast expansion of employment in sectors where such expansion is essential in the years ahead, to counteract the trends toward technological displacement in other key sectors.

The alarming long-term decline in housing and nonresidential construction investment, especially when related to current and future national needs

The data which I shall now present demonstrate the absolute contrast between the severe and prolonged deterioration in these vital sectors and the provisions of the Bill designed to provide them with even less tax incentives than they now have. This, although on all sides, including other long-range Federal programs involving scores of billions of dollars over the years ahead (in declarations of Congressional intent, but not in actual appropriations), we have been proclaiming that the rescue and renewal of our urban areas is our most critical domestic priority.

Private nonfarm housing starts declined, on a seasonally adjusted annual basis, from 1,845 thousand units in January 1969 to 1,314 thousand units in July, or 28.8 percent, and the end is not yet. The ratio of housing and commercial construction investment (combined) to GNP declined from 7.13 percent in 1950, and 5.93 percent in 1959, to 4.39 percent in the second quarter in 1969; as a percentage of gross domestic investment, the decline was from 40.8 percent in 1954, and 39.4 percent in 1958, to 29.0 percent in the second quarter of 1969. During 1961–1968, measured in uniform dollars, the average annual growth rate in investment in commercial construction was only 4.9 percent, and in housing only *0.5 percent*, while it was 5.2 percent for GNP, and 9.9 percent for investment in producers' durable equipment. In contrast, and in line with balanced goals for the whole U.S. economy, the annual average rate of advance through 1977 in commercial structures should be 5.9 percent, and in residential structures 11.2 percent, compared with 5.3 percent in GNP, and 4.1 percent in producers' durable equipment.

Disparities in Federal stimuli provided

The vital areas needing the most help have been given the least, and, in the main, *vice versa*. In 1966, of the 43.1 billion dollar value of depreciation and depletion allowances, 45.7 percent went to manufacturing, and only 5.8 percent to real estate. During the fiscal years 1954–1969, viewing more than 6.7 billion dollars of average annual net expenditures for Federal subsidy programs, 57.9 percent were going to agriculture, 10.5 percent to air transportation, and only 2.9 percent to housing.

The lowly financial position of real estate

Contrasted with the belief that real estate is "in clover", that industry is doing worse by various financial tests than any of seven other basic industries which I have analyzed. Viewing net income as percentage of net worth, the figure in 1965 for real estate was 3.5 percent, compared with 6.0 percent for finance and insurance, 10.3 percent for manufacturing, and 8.2 percent for all industries.

The toll of rising interest rates

The impact of rising interest rates has borne most severely upon housing and other aspects of real estate investment, because, in real estate, long-term debt comes to almost 50 percent of total assets, compared with 12.2 percent for all industries. Since 1952, rising interest rates alone have imposed an excess cost aggregating more than 17 billion dollars in connection with mortgages on 1 to 4 family homes. The rising interest burden imposed upon housing and supportive non-residential commercial investment has exceeded many, many times the total benefits flowing to these sectors through all types of Federal tax concessions.

Under these conditions, it would seem to be an upside-down public policy, or fiscal policy, to make the public stimuli available to these sectors, including those in tax form, even less favorable than they are now, and increasingly discriminatory as against other sectors. This is true, not only in terms of economic and social considerations, but also in terms of the revenue problems of the Federal Government viewed more narrowly. Any recoupment of Federal revenues by further tightening up in these sectors would be a mere bagatelle, compared with the potentials for recoupment along beneficial rather than damaging lines when measured in terms of economic activity and human well-being.

Specific provisions of the Bill relating to housing and nonresidential commercial investment

There is not room, in this very abbreviated summary of my testimony, for me to deal fully with the specific provisions of the Bill which would have these deleterious effects. But briefly, the provisions which would be damaging to both housing and nonresidential construction investment include substitution, in the case of used buildings, of straight-line depreciation for the presently allowable 150 percent declining balance method (sec. 521); the recapture provisions (sec. 521); the treatment of "excess" deperication under LTP and allocation of deductions (secs. 301, 302); the limitation on interest deductions (sec. 221); the "additional preference" Treasury proposal; and certain retroactive features of the Bill. Applicable to new nonresidential structures but not to housing, there is also the undesirable substitution of 150 percent declining balance method for the double declining balance method. These technicalities are dealt with in detail in my full testimony.

Summary related to housing and nonresidential commercial investment

If there were time, I respectfully submit that this Committee should be dealing with methods to accelerate housing and nonresidential commercial investment, instead of adding to its present plight. The least that should be done now is not to do the latter.

The difficulty with some of the so-called reform provisions of the Bill, relating to housing and nonresidential commercial investment, is that the baby is being thrown out with the bath. In the laudable desire to catch those who are "getting away with something", scores of thousands of worthy and essential enterprises will be hit who are not now getting away with anything, but instead serve the national interest. Indeed, while the Bill in its present form attempts to catch those who are geeting away with too much in some industries, by delimiting some of the special tax incentives they have enjoyed, such as accelerated depreciation, it does not apply the same method to those in other industries who are generally or even to a greater degree getting away with something. The Bill makes this distinction on the ground that these are the industries requiring stimulation. But that is no justification for anyone getting away with something in such industries.

The appropriate method to catch those who are getting away with something is by limiting total allowable deductions, so as to permit none to pay too small a percentage of their incomes, or zero percentage, in taxes. The provisions of the Bill intended to do this should be further strengthened. But the enlargement or contraction of special tax incentives should relate to the condition of the industry affected, and its relationship to national needs. That has been forgotten thus far, in the treatment of housing and nonresidential commercial investment. I earnestly hope that this Committee will help to correct this dangerous imbalance.

STATEMENT

Mr. Chairman and members of the committee, I appreciate this opportunity to appear before you, during your consideration of one of the most important tax measures, and in fact one of the most important economic measures, in many a year. Those in the Congress and elsewhere who have thus far toiled so diligently this year to make our Federal tax system more equitable, and to improve it as a fiscal weapon toward achieving and maintaining the maximum employment, production, and purchasing power objectives of the Employment Act of 1946, deserve the commendation of all thoughful citizens. I have high hopes that changes in the Bill now before this Committee will bring about improvements in it which are still vitally needed.

General considerations

I appear here today on behalf of the Realty Committee on Taxation (an Appendix to my testimony describes this Committee) with respect to those provisions in the Bill bearing upon housing and other aspects of real estate investment, although all of my analysis and conclusions have been arrived at independently, and I believe in the public interest. However, a major portion of my testimony deals with portions of the Bill other than those affecting real estate. This is in part because I believe this is essential to shed adequate light upon the portions dealing with housing and other aspects of real estate investment, and in part because I cannot refrain from this opportunity once again—as many times in the past—to bring my general economic and fiscal views before this Committee. This major portion of my testimony is offered, not on behalf of the Realty Committee on Taxation, but rather in my independent capacity as an economist who has tried to devote a major portion of his time and efforts to problems of the American economy and the American people.

Some provisions of the Bill, even as it now stands, would greatly improve the equity of the tax structure, and help to close some unconscionable tax loopholes which have persisted for far too long. But viewed as a whole, the Bill, in my judgment does not go nearly far enough in the direction of improving the equity of the Federal tax structure. In addition, on net balance, the allocation of the various tax changes proposed, based as they are upon faulty economic diagnosis, would worsen rather than improve the economic equilibrium, and thus militate against restoration of maximum employment, production, and purchasing power. And in the name of reform, some of the proposals if enacted, especially those bearing upon housing and related commercial construction, are ill-designed and ill-timed, would further distort the treatment of our great national priorities, would conflict seriously with other programs and objectives to which the Federal Government on a long-range basis is committing billions of dollars, and would seriously increase unemployment and work against economic growth. The net relinquishment of Federal revenues which would result from the Bill as now drawn might not be too large if the composition of the proposals were drastically changed, but is much too large so long as these proposals retain their current composition. This is because some of the reductions and concessions are unwarranted both economically and socially, and should have substituted for them a larger prospective revenue take by the Federal Government and the allocation of these revenues to the services of our great domestic public priorities. In all of these connections, I shall say something about the problem of inflation.

We are far too prone to consider current tax proposals without an adequate review of the lessons of the past, and without setting these tax proposals in the controlling perspective of our overall economic and financial capabilities and needs, as well as our social objectives as a nation and a people. In order to help restore the balance on these scores, I shall refer, at various stages in my testimony, to my studies and findings in opposition to the massive tax cuts of 1964, and indeed to the whole series of changes in the Federal tax system during 1962–1965. At various times in the past, these studies and findings have been brought to the attention of this Committee, by my direct testimony and otherwise.

In brief, my line of argument has consistently been that these 1962–1965 tax cuts and concessions, and especially those in 1964, would undoubtedly stimulate the economy for a while after their enactment. But I pointed out insistently that, in the longer run, they would work against adequate economic growth, because the allocation of the cuts and concessions were so far out of line with the requirements for economic equilibrium at reasonably full resource use. I also forecast that these tax actions would increase the problem of inflation and the balance of payments, because they were founded upon incorrect diagnosis of both of these problems. I insisted that the distribution of these tax cuts and concessions were indefensible from the viewpoint of equity. Last but not least, I took the position that such huge amounts of tax cuts and concessions were at the expense of imperatively needed domestic priority-spending programs which, in words but not in action, had long been declared for by almost all responsible groups, including the Federal Government itself. Because in my judgment some of these errors are now being repeated in the current Bill as now drawn, and because they are highly relevant to the specialized subject of housing and other aspects of real estate investment, I feel justified in the review of developments to date, which I now will undertake.

The core problem of inadequate economic growth

My *Chart 1* shows that we have fallen far short of achieving the goal of sustained and optimum economic growth. From the enactment of the massive tax cuts in 1964 to the middle of 1965 or thereabouts, the rate of real economic growth was rewardingly high. But by then, definite signs of serious faltering were clear. But we were "saved" for a time by the vast and unexpected increase in defense spending due to the Vietnam war (by which I imply no evaluation of our international policies). However, even with these vast increases in defense spending, the real growth rate of the economy dropped to 2.5 percent from 1966 to 1967, and averaged annually only 3.7 percent during the 1966–1968, compared with the 5.1 percent averaged annually during the 1960–1966 with remarkably stable price levels. It is now estimated that the real rate of economic growth during 1969 may be only in the neighborhood of 3 percent, and might get even lower before it gets better. This is a dangerously poor performance, in view of our domestic and international obligations and burdens, and in view of the fact that maintenance of so low a growth rate for much longer will lead to serious increases in unemployment. Even today, unemployment, when fully measured, is far too high among vulnerable groups, and we should all know by now what this imports in terms of civil and social unrest and disorder, apart from being unacceptable on all other grounds.

Considering also that plants in general are now operating on the average at only about 84 percent of capacity, when they should be running well above 90 percent, the clamor about an "overheated" economy is a profound and costly error, in terms of the relationship between our human and other production capabilities and our actual production of goods and services. The term "overheated" is properly applicable to the excessive price inflation, but it is utter confusion—for reasons which I shall demonstrate—to mistake this rampant price inflation for an "overheated" or overstrained economy in a true sense. Entirely to the contrary, the rampant inflation is in large measure due to the very fact that the economy is not performing adequately in real terms.

My *Chart 2* depicts the costs of deficient economic growth in the U.S. economy. I estimate that, during the period 1953–1968 as a whole, we forfeited more than 917 billion dollars of total national production (measured in 1970 dollars), and lost more than 38 million man-years of employment opportunity, in consequence of the deficient average annual economic growth rate. In 1968 alone, our economy was operating almost 82 billion dollars below total national production, and this was accompanied by more than two million man-years of excessive unemployment (based upon the true level of unemployment, including full-time unemployment, the full-time equivalent of part-time unemployment, and concealed unemployment in the form of nonparticipation in the civil labor force due to scarcity of job opportunity). And if the rate of real economic growth during 1969–1977 should average annual approximately the same as during 1953–1968, we would forfeit considerably more than a trillion dollars of total national production, and experience more than 31 million man-years of unemployment in excess of the minimum unemployment consistent with maximum employment. When we see and hear on all sides the evidence of a nation torn by the perilous conflict between those who insist that we "cannot afford" to keep our guard up in the world if we attempt to vindicate our great domestic priorities, and those who insist that we "cannot afford" to vindicate our great domestic priorities unless we let down our guard all over the world, I am amazed that economists and others have in so great degree lost sight of the potentials and implications of the great nonsecret weapon of America's productive power if fully called forth.

To indicate these potentials, my *Chart 3* sets forth a balanced series of goals for the U.S. economy, projected from actual levels in 1968 to the years 1972 and 1977, and set forth at the fiscal 1969 price level as estimated at the time of the President's fiscal 1970 Budget submission. One aspect of this portrayal, which is especially relevant to the Bill now before this Committee, are the uniquely high rates of expansion set forth as needed for residential construction. Another aspect, extremely relevant to the current Bill in general, are those portions of the chart which indicate how much we can afford (without appreciable changes in tax rates at the Federal level, and without distorting traditional ratios between private and public endeavors) to enlarge the Federal, State and local levels those types of public spending which are the only means of vindicating the most urgent of our domestic priorities—if only we restore and maintain the maximum rate of real economic growth to which we are committed by the Employment Act of 1946, and even more importantly are committed to by the realities apparent everywhere on the current scene.

Economic equilibrium and tax policy

To maintain the economic equilibrium required for optimum economic growth, we must examine the requirements for equilibrium, and also examine the high relevance of Federal tax policy to the maintenance of such equilibrium. In this connection, my *Chart 4* sets forth a series of balanced goals for the Federal Budget, geared to economic growth and priority needs. I will not dilate here upon the various programs set forth in this model Federal Budget, except to say that their realization would bring us close by 1977 to a land in which we no longer suffered from substantial poverty, slum living for one-sixth of our people, poisonous airs and waters and neglected natural resources, vast disparities in agriculture and rural life, ramshackle and understaffed public schools, and health services beyond the reach of scores of millions of our people at costs within their means. A distinctive feature of this chart is the indication that Federal outlays recommended for 1977 would be smaller in ratio to our national production than in 1969. Another feature of this projected 1977 Federal Budget is that, in absolute amounts, quite reasonable or even liberal allowances are made for national defense, space technology, and all international, without any sacrifice of the great domestic priorities. Looking at the composition of the tax changes proposed in the current Bill as it now stands, I cannot believe that these proposals stem from an adequate analysis of our economic, financial, and social problems and potentials in full perspective.

Most seriously of all, I do not believe that the proposals in the current Bill in its present form are designed to stimulate and activate the full but not excessive rate of real economic growth which we need and can achieve. The long term departure from adequate economic growth, not only to an extraordinary extent during 1953–1960, but also to a lesser although serious extent during 1960–1969, has been occasioned fundamentally by a gross misallocation of economic activity and the incomes supporting and inducing such activity, from the viewpoint of economic equilibrium. Each period of real economic slow-down or stagnation or recession has been preceded by a relatively excessive expansion of the ability to produce as represented by private business investment, and especially private investment in plant and equipment, at the expense of relatively inadequate expansion of ultimate consumption in the form of private consumer spending and public spending at all levels, combined. My *Chart 5* demonstrates this for the period 1961–1968. Measured in constant dollars, while total national production grew only 42.2 percent, private business investment in plant and equipment grew 65.5 percent. While wages and salaries grew only 44.5 percent and farm proprietors income only 3.6 percent, corporate profits grew 55.4 percent, personal dividend income grew 58.0 percent, and personal interest income grew 84.9 percent. During 1967–1968, a reaction set in, which almost brought to a halt the expansion of private investment in plant and equipment, due to obvious overcapacity; but even so, corporate profits grew 7.1 percent while wages and salaries grew only 5.6 percent and farm proprietors' net income only 1.4 percent. We all know that, during 1969 to date, private investment in plant and equipment is again proceeding at a fantastically high and dangerously nonsustainable rate relative to the rest of the economy, while progress in the real incomes of wage-earners and farmers and millions of other people of lower and moderate incomes has been virtually brought to a halt, or even set back in real terms, due in large part but not entirely to rampant price inflation.

Federal spending for some of our public domestic needs is being cut back drastically. Total Federal spending on the domestic scene is being held for below either our economic equilibrium or our social needs. And total Federal spending, in fact, is insufficient to close a reasonable portion of the gap between other types of spending and the spending requirements for maximum employment, production, and purchasing power and optimum economic growth.

Certainly, these disparate trends all along the line must be promptly and vigorously corrected, lest we instigate an even more deficient real economic performance than is currently in process, instead of moving in the directions we ought to go. All of these considerations, as I shall show, are directly related to the portions of the Bill bearing upon housing and other real estate investment.

Current tax bill, investment and consumption allocations

Bearing these considerations in mind, I turn now to specific consideration of the current Bill, beginning with an analysis of its allocations between the investment fuction and the consumption function, which, as indicated above, I hold to be fundamental to all other considerations. First of all in this connection, I call the Committee's attention to my *Chart 6*, making manifest my early protest against the unsound nature of the allocations between the consumption function and the investment function, as embodied in the tax cuts and concessions during 1962–1965. In view of what has happened since, I hardly see how many responsible economists could now challenge the validity of the position I then took, although I had mighty few supporters at that time. Be that as it may, I feel that the proposals in the current Bill, while less egregiously so than earlier, run counter to the considerations of an appropriate and viable balance between investment and consumption.

This crucial subject is dealt with on my *Chart 7*. Excluding the proposed tax reforms, it indicates that, on net balance, the House Bill would increase the after-tax benefits to investment only nominally, while the Treasury proposals would increase the after-tax benefits to investment by 1.1 billion dollars, in both instances allowing for the effects of the repeal of the investment tax credit. Taking into account the entire train of events to date as I have discussed them above, and the allocation to the investment function in the neighborhood of 8.6 billion dollars by the tax actions of 1962–1965, I can find no justification whatsoever for the current proposals, excluding the proposed tax reforms. It seems to me highly inconsistent and ironic that, despite all of the furor about excessive investment and the need to restrain it by repealing the investment tax credit (which repeal I highly favor), the effect of without reforms of the House Bill is to cancel out a major part of the impact of the repeal of the investment tax credit by other concessions to saving for investment purposes, while the net effect of the Treasury proposal is to far more than counteract such repeal (for details, see third following paragraph).

I deem this analysis of the impact of the current proposals excluding the tax reforms to be more significant than the analysis including such reforms. The reforms are more controversial than the other sections of the proposed Bill, all experience indicates that there is much more doubt as to how the reforms will come out in the final legislation, and besides, some of the so-called reforms are highly undesirable for reasons which I will disclose as my testimony proceeds.

However, if the tax reforms are included, as shown on the lower portion of my *Chart 7*, the House Bill would result in a net after-tax tightening up on the investment function in the amount of 3.9 billion dollars, and the Treasury proposals would do this in the amount of 2.5 billion dollars. These provisions do not go far enough.

My own suggestion is as follows: the investment tax credit should be repealed. The additional tightening up on investment (related both to after-tax funds available directly for investment and after-tax personal income saved for investment purposes) as embodied in the House Bill, including the reforms, should be enacted, subject to some modifications which I set forth below. Investment in many basic areas is far too ebullient. Profit margins in general are high enough and in many key instances far too high. And even from the viewpoint of investment and profits in the long-run, the best results will be obtained by more accent upon private and public consumption to restore the economic equilibrium, and thus to promote the higher rate of real economic growth, in which business shares very generously. It follows that, while I favor the small additional incentives to investment in the form of accelerated depreciation for anti-pollution efforts, etc., I favor neither the 2.0 billion dollar after-tax benefits to investment embodied in the House Bill (with or without the reforms), in the form of the estimated impact upon personal saving for investment of personal tax cuts less the impact upon individuals of the repeal of the investment tax credit, nor the 3.3 billion dollar after-tax benefits to investment embodied in the Treasury proposals (with or without the reforms), including also corporate tax relief. The about 6 billion dollar decrease in the after-tax allowance to investment which I favor could beneficially be utilized in the form of additional Government revenues distributed to the great priorities of our domestic needs, which are now being so seriously starved. Even this would be beneficial to investors in the long run by adding to economic growth, human justice, and social contentment. As I shall make abundantly clear as I proceed, while I favor this *amount* of net tightening up on investment, my comments are not applicable to housing and related real estate investment. Further desirable tightening up in other areas would yield this 6 billion dollar net without tightening up on housing and related real estate investment.

Equitable considerations in the tax bill

I turn now to equitable considerations as distinguished from the purely economic equilibrium considerations set forth above, although I must stress most emphatically that the whole problem of departures from economic equilibrium is at bottom a problem of serious income maldistribution. Improved income distribution would do more than anything else to help restore and maintain that balance between investment and consumption which is essential to optimum economic performance, and to the achievement of the enlarged public revenues (at any given tax rates) which flow from such optimum performance.

In this context, I turn first of all to my *Chart 8*, which indicates as of 1967 the annual money incomes before taxes of various income groups, as these groups relate to poverty, deprivation, comfort, and affluence. I will not linger upon this demonstration, except to state that it indicates dramatically the need to use Federal tax policy to improve income distribution. The chart also shows 1972 and 1977 goals for the reduction of poverty, within the model for balanced economic growth earlier set forth in this testimony. My *Chart 9* shows even more vividly and terribly indefensible income distribution in the U.S. from 1947 to 1966, and further indicates a totally unacceptable amount of improvement over the years. In 1966, as to families, the top one-fifth income grouping received 41 percent of total income; the two top fifths received 65 percent of total income; the lowest fifth received only 5 percent; the lowest two-fifths only 17 percent; and the three fifths counting from the bottom received only 32 percent. As to unattached individuals, the situation was, in some respects, very much worse.

To divert for a moment, this whole problem of income distribution and the need for vast improvement is intimately associated with housing conditions, home construction, urban renewal, and related aspects of other real estate investment. These activities not only increase incomes directly by adding to employment opportunity, but increase it indirectly by income-aids to many forms of housing, and by removing the oppressive housing conditions which impair morale, health, productivity, and incentives. In due course in my testimony, I will develop the truly dangerous extent to which a number of provisions in the current Bill, as now written, would devastatingly affect these lines of enterprise.

In view of rapid inflation and other developments, it may well be that the distribution picture in 1969 is even more shocking than it was in 1966.

Mindful of this core problem of income distribution, I have not only emphasized for many years the value of maintaining a highly and even increasingly progressive Federal tax structure, but also have called attention to how misleading it is—though many who know better do so—to look only at the Federal income tax structure, in appraising whether or not we have anything approximating an equitable tax structure in the U.S. In 1966, as shown on my *Chart 10*, scrutiny of the Federal income tax structure alone would indicate a moderately progressive tax system, although not nearly as progressive as I think it should be. But people do not only pay Federal income taxes. They also pay social security taxes; State and local income, sales, and gasoline taxes; and personal property and real estate taxes. Taking all of these types of taxes into account, those with incomes under $3,000 in 1966 paid 14.1 percent of their incomes in taxes of all kinds, contrasted with the 3.7 percent which they paid if one looked only at the Federal income structure. To be sure, these people and some others will pay no Federal income taxes if the proposals now before this Committee are enacted, and that is all to the good. But taking into account what has been happening to other types of taxes, many of these people will probably pay a higher percent of their income in total taxes after this Bill is enacted than in 1966.

Turning again to 1966, those with incomes of $3,000–3,999 paid 19.3 percent of their incomes in all forms of taxes, or *more* than those in the groups running from $4,000 up to $14,999, and almost as much as those running from $15,000 to $19,999. Those from $20,000 to $49,000 paid 24.2 percent of their incomes in all kinds of taxes, contrasted with 19.3 percent for those from $3,000 to $3,999, while if one looks at the Federal income tax alone the contrast would appear to be between 18.7 percent and 6.6 percent. Those with incomes at $50,000 and over paid 38.8 percent of their incomes in all forms of taxes, which in my view was not nearly enough when compared with some of the other groups, particularly in view of the unique opportunity which many within these groups have to avoid if not to evade taxes. Further, comparison between this 38.8 percent figure and the 33.6 percent figure which indicates the share of these peoples' incomes which they pay in Federal income taxes alone shows vividly how much less heavily other types of taxes serve (proportionately) to increase the tax payments of these people when compared with those down in the income structure.

These were the reasons why, prior to enactment of the massive tax reductions in 1964, I protested the distribution of the tax cuts on the grounds that they were grossly inequitable. I insert in the record, at this point, my *Charts 11, 12, 13, and 14*, shedding light upon what happened in 1964. It is true that these charts were developed in 1963, and are not exactly in accord with what actually happened in 1964. But they are close enough to tell the essential story. And it should be remembered that most of the reforms were sidetracked in 1964, so that the portrayals without the reforms are the really significant ones.

The current consideration of what is hailed as "the greatest tax reform bill on record" provides a challenging opportunity, not only to avoid repeating in full measure the errors of 1964, but to commence to redress vigorously the worsening of the tax structure then accomplished, by a really progressive treatment of any tax changes put into effect henceforth. But by this entirely fair test, the Bill in its current form is woefully deficient.

As my *Chart 15* shows, looking at both the House and the Treasury proposals, and also looking at the Bill without the reforms and the Bill with the reforms, those with incomes under $3,000, aggregating 38.8 percent of all tax returns, would receive only 9.0–13.7 percent of the total tax cuts. Those with incomes of $3,000 to $5,000, aggregating 16.2 percent of total returns, would receive only 7.8–14.1 percent of the total tax cuts. Meanwhile, those with incomes of $20,000 to $50,00, coming to only 2.3 percent of total tax returns, would receive 10.6–16.1 percent of the total tax cuts. Those with incomes of $5,000 to $10,000, aggregating 33.9 percent of total tax returns, would receive only 22.1–30.7 percent of the total tax cuts. Those with incomes of $10,000 to $20,000, aggregating 16.4 percent of total tax returns, would receive 28.5–34.4 percent of the total tax cuts.

Without the reforms, those with incomes of $50,000 and over, coming to only 0.4 percent of the total tax returns, would receive 13.4 percent of the tax cuts under the House Bill, and 17.2 percent under the Treasury proposals. And in many ways, the comparison shown on the chart without the tax reforms are more significant than those shown with the tax reforms. This is because the tax reforms are the most debatable and the most uncertain as to enactment; because we know from experience that, when the reforms are dropped or mutilated, there are unlikely to be corresponding adustments with respect to the general tax rates; and because the tax reforms bear down so very differently upon different people in the same income groupings, depending upon the nature of their incomes. For example, under the Treasury proposal, those in the $10,000 to $20,000 income group would get a much higher percentage of the total tax reductions with the reforms than without them, while the over-$50,000 income group would receive an immensely greater percentage without the reforms than with them.

I know that it will be argued, as it has been, that under a progressive tax system, it is "natural" that a larger percentage of the tax cuts (relative to numbers of taxpayers) should go to those higher in the income structure than those lower down. The first answer to this is that it is hardly true. It is perfectly feasible to realign the composition of the tax cuts in the current Bill to achieve the reverse. In the second place, even if it were true, this would merely cast doubt upon tax cutting as the desirable measure now to be used, in either economic or social terms. If under tax cutting, it were not feasible to direct a larger percentage share of the benefits of total action taken by the Government to those lower down in the income structure than the current Bill does in its present form, in that event devices other than tax cutting should be used toward these essential ends—for example less tax cutting in the higher parts of the structure, and more Federal spending directed toward the needs of the poor and deprived.

Beyond all this, the really meaningful thing is not the percentage tax cut, but the percentage *increase in after-tax income*. As shown by my *Charts 13 and 14* already referred to, I indicated how bad the 1964 tax action was by this test. And as shown by my *Chart 16* while it would appear by looking at the percentage cuts in their taxes which would be applied to various income groups that the proposals in the Bill are quite progressive, the true and very different picture is shown by looking at the percentage increases in after-tax income, which is what really counts.

Looking first at the House Bill as is shown on the lower half of *Chart 16*, with or without the reforms, the income groups under $5,000 would be treated relatively well, though not nearly well enough. But those in the $5,000 to $10,000 groups would be treated the same as those in the $10,000 to $20,000 groups, and less favorably than those in the $20,000 to $50,000 group. Those above $50,000 would be treated immensely more favorably than others if one excludes the reforms, and in some ways the exclusion of the reforms is very pertinent, if not most pertinent. For as I have said, nobody knows what is going to happen to the reforms; we have learned from experience that the general changes in the structure are not revised when reforms are dropped in the process of legislation; and beyond all this, there will be many in the over-$50,000 group who will not be affected by the reforms in a degree comparable to others in this same group.

Coming over to the Treasury proposal, as shown on *Chart 17*, those in the income group $20,000 to $50,000, in terms of percentage increase in after-tax income, would be treated much more favorably than those between $3,000 and $20,000, with or without reforms. Without the reforms, those at $50,000 and over would be treated immensely more favorably than all others.

My position on this entire issue is extremely simple. To make the tax structure more equitable, to serve better our economic equilibrium needs, and to commence to redress some of the gross regressiveness brought into being by the 1964 tax changes, I submit that this is not the time at all to reduce one iota the personal tax rates, before reforms, applicable to those with incomes of $50,000 and over. All things considered, I have considerable doubts as to whether such tax reductions, before reforms, should be extended to those with incomes over $20,000. The amounts saved by forgoing these types of tax reductions should be used toward increasing the tax reductions or concessions lower down in the structure, with emphasis upon progressivity. With respect to those over $50,000, the only group where the reforms as against the tax reductions without the reforms changed the picture much, I do not believe that any of the reforms enacted to apply to these groups should result in their getting any tax reductions without reference to the reforms. The need for reforms does not depend upon the general tax structure as applied to these groups, and those among them who are getting away with what the reforms are designed to avert should not thereby be entitled to reductions in their general tax rates.

Everything else being equal, tax reduction of all kinds is fine for everybody. But everything else is not equal. What I am urging in essence is that, on all valid grounds, we should use any changes to be made in the personal income tax structure, whether considered with or without the effective reforms, to begin to redress the gross maldistribution of income after taxes which is now so unfair to our people and injurious to the economy. This in itself would be the greatest reform of all, and a Bill which does not really do this anywhere near adequately is using the glamorous word "reform" to mask the real results which would flow from its enactment.

In addition, I believe that the minimum tax provisions in the Bill should be very considerably strengthen. Among other advantages of doing this, it would reduce the real or alleged need for some of the so-called reforms, with which I shall deal in detail when I come to those provisions in the Bill which treat housing and related aspects of real estate investment.

I think also that there should be some tightening of existing law related to capital gains, although I am not positive as to the timing thereof, nor have I examined the technical aspects in detail. But, as I later discuss, housing and other real estate investment should not in this connection be singled out for discriminatory treatment.

I also feel that the maximum tax provisions should be eliminated or very substantially modified, for reasons going to the general issue of restoring a sufficient degree of progressivity in the Federal tax structure.

On revenue and other grounds, these changes would leave much more fiscal room for reconstruction of the so-called reforms bearing upon housing and related aspects of real estate investment, although this reconstruction is essential in any event.

Another net consequence of my proposals in their entirety is that they would result in somewhat less net forgoing of Federal revenues than the Bill in its present form, even assuming that tax relief for those in the low and lower-middle-income brackets were carried, as they should be, further than the Bill proposes in its current form.

On the score of general fiscal considerations, I am not interested in improving the revenue position of the Federal Government *per se* as, for reasons fully stated above, I believe that the economy needs net stimulation, not net restraint.

But things being what they are and views being what they are, I feel that the improvements in the Federal reveune picture which would result from my proposals in their entirety would leave more room for more realistic consideration of the so-called reforms bearing upon housing and other aspects of real estate investment, which I shall treat very fully later on in my testimony.

The problem of inflation

The problem of rampant inflation is now at the center of the stage of national attention. It certainly deserves consideration in connection with fiscal policy. In view of the import of my entire testimony, to the effect that we should seek at once to accelerate the rate of real economic growth, I deem it essential to attempt to set the problem of inflation in a more analytic and realistic perspective than I think is represented by recent and current highly unsuccessful efforts to deal with inflation. The materials which I bring before this Committee in this phase of my analysis have been called to its attention by me a number of times in recent years. Only because the issue is so important do I deem it appropriate to say, in passing, that actual economic developments to date have verified to a remarkable degree those conclusions which I commenced to set forth many years ago, and which were viewed with very widespread skepticism when first I set them forth.

Essentially, and contrary to the more common view, I hold that the inflation in the U.S. since the end of the Korean war has been augmented by a dificient rate of real economic growth, rather than sparked by an "overheated" economy. I feel that the effort, through tight money and rising interest rates, to fight inflation has repressed most undesirably the real rate of economic growth, even while it has added greatly to the inflation itself. I feel further that this policy of tight money and rising interest rates has disorted the economic equilibrium, by allocating too much income and incentives to the wrong lines of economic endeavor, and subtracting too much income and incentives from those lines of economic endeavor which require large acceleration, in the interest both of economic equilibrium and our great national priorities. The tight money and rising interest rates have also contributed mightily to the maldistribution of income. As I have frequently commented, they have fed the fat and starved the lean.

There is no better example of this than the housing industry and related aspects of other real estate investment. Here I am not, and for a long time have not been, in a minority; practically all informed persons have recognized the monstrosity of tight money and rising interest rates as applied to these economic sectors. But they have argued that the policy is necessary, nonetheless, to fight inflation by repressing economic growth. That argument also enters into the provisions of the current Bill pointed toward these sectors.

I will not here go into all of my reasons why tight money and rising interest rates are highly inflationary *per se*, but only set them forth very briefly. An increase in the price of steel is more inflationary than an increase in the price of bananas, because steel enters into more products. Money and the cost of money enters into more products than anything else, and thus increases in the cost of money will pyramid into rising costs and prices, including a large portion of those increases in wage demands which are related to that part of the increased cost of living due to rising interest rates all along the line. Tight money and rising interest rates, by repressing the rate of real economic growth and leading to excessive idleness in plant and manpower, reduced seriously the rate of productivity gains. This in itself is inflationary for many reasons, including the reason that it changes adversely the ratio between the trends in labor costs and the trends in money-wage gains.

Instead of elaborating further on a theoretical basis, as to why the repression in the economy which results from tight money and rising interest rates is inflationary *per se*, I now call attention to my *Chart 18*, which is empirical in that it looks at what has actually been happening, instead of indulging in classical theories which do not square with modern realities.

During 1952–1955, as shown on this *Chart 18*, the average annual rate of consumer price inflation was only 0.3 percent, when the average annual rate of real economic growth was 3.5 percent, and unemployment as officially counted averaged 4 percent. During 1955-1958, the average annual increase in consumer prices was 2.6 percent, although the average annual rate of real economic growth was only 0.8 percent, and unemployment averaged 4.9 percent. During 1956-1958, the average annual increase in consumer prices was 3.1 percent, while the average annual rate of real economic growth was only 0.2 percent, and unemployment average 5.1 percent. During 1958-1960, the average annual rate of consumer price inflation fell back to 1.2 percent, while the average annual rate of real economic growth was 4.3 percent, and unemployment averaged 6 percent. During 1960-1968, the average annual rate of real economic growth rose to 4.8 percent, and the average annual increase in consumer prices was only 2 percent. Unemployment average 4.9 percent, but was reduced greatly to 2.6 percent by 1968. During 1960-66, the average annual increase in consumer prices was only 1.6 percent, while the real rate of economic growth averaged 5.1 percent. Unemployment averaged 5.3 percent, but was reduced to 3.8 percent by 1966. During 1966-1968, the average annual rate of increase in consumer prices was 3.7 percent, although the average annual rate of real economic growth fell to 3.5 percent. Unemployment averaged 3.7 percent, or almost the same as the 1966 level. The trends in wholesale prices and industrial prices are shown on the same chart, but I do not analyze them in detail because they tell basically the same story.

Certainly, these trends in the main indicate an inverse or negative rather than a positive correlation between the rate of real economic growth and the rate of price inflation. Nor do they indicate in the main that a movement toward reduction in unemployment promotes an increase in price inflation.

But it may be argued that, while a higher rate of real economic growth or a lower level of unemployment does not in itself promote inflationary tendencies, inflation is nonetheless promoted by an economy *moving toward reasonably full or optimum resource use.* However, this thesis is also discredited by the trends depicted above. For example, during 1956-1958, with unemployment averaging 5.1 percent, and with the sharpest recession since 1952 occurring within that period, the average annual rate of consumer price inflation of 3.1 percent was about twice as fast as the 1.6 percent average during 1960-66 when unemployment averaged 5.3 percent, or about the same. From 1966 to 1967, the price inflation was 2.8 percent, and unemployment stood at 3.8 percent.

The analysis could be further complicated, and my conclusion might be somewhat modified, by the introduction of time-lag factors and some others. But I submit that my analysis and conclusions are in the main sustainable, and most assuredly do not justify the unalloyed policies which are at times deliberately sought to generate excessive deviations from optimum real economic growth, and at least to tolerate excessive unemployment, in the pursuit of a nonsustainable propostion bearing upon the relationship between price trends and these other factors.

My own explanation of inflationary trends—which I commenced to set forth in the mid-1950's before future experience lent much further support to my position—runs as follows: In an economy characterized so largely by administered prices, an inadequate volume of real economic activity and insufficient employment, or even the clear prospect of these, tends to generate protective efforts to compensate for these deficiences through the managerial price-making process. This thesis is perhaps most clearly borne out by the resumption of a relatively high rate of price inflation from early 1966 forward, when the signs became large and unmistakable that the economy was entering a period of severely reduced real economic growth, and when recession talk was in the air.

In some other areas, such as medical care and housing, and at times in the area of farm prices, rising costs or prices have been due to entirely different factors. In the medical field, there have been shortages of facilities and personnel relative to the real need, engendered by long neglect of adequate public spending for these purposes, such neglect being fomented by the avowed desire to fight inflation. In the area of housing, rising costs have not been due to excessive aggregate demand for housing relative to the Nation's needs, but instead have been due in large measure to the fantastically rising interest rates, again allegedly designed to fight inflation. Rising costs to occupants have also been due to the housing shortage.

The thesis that excessive aggergate demand (which in fact we have not had any time in recent years, when measured against the demand required to sustain optimum economic growth and bring unemployment low enough) explains the inflations during recent years, and particularly during 1967-1968, breaks down at all points. It is further corroded by the special industry studies which I have made from 1952 forward, indicating even more clearly the propensity to increase prices more rapidly during periods of relatively high unused capacity and relatively high unemployment than during period of relatively less unused capacity and relatively less unemployment.

Frequently it is argued that the inflation has been of the cost-push variety, occasioned by wage costs per man-hour rising faster than productivity. But this position is completely torpedoed by the empirical evidence.

During 1960-1968, in the total private nonfarm economy, measured appropriately in constant dollars, productivity rose at an average annual rate of 3.1 percent, while hourly wages and salaries rose at an average annual rate of 2.9 percent. It is even more reveling to break this period into two parts. During 1960-1966, productivity rose at an average annual rate of 3.4 percent, while wages and salaries rose at an average annual rate on only 2.7 percent. This was a period when the average annual rate of real economic growth was 5.1 percent. But during 1966-1968, when the average annual rate of real economic growth declined to 3.7 percent, productivity rose at an average annual rate of only 2.2 percent, and wages and salaries at an average annual rate of 3.2 percent.

The trends in manufacturing tell the same story, only more so. During 1960–1968, the figures were 3.2 percent for productivity, and 2.2 percent for wages and salaries. During 1960–1966, the figures were 3.7 percent for productivity, and 1.9 percent for wages and salaries. During 1966–1968, the figures were 1.7 percent for productivity, and 2.9 percent for wages and salaries.

This leads to the implication that the relative trends during 1966–1968 exerted cost-push inflation, and thus explained the rapidly accelerating inflationary trends. I cannot accept the position that the relative trends in wages and salaries and productivity during 1966–1968 justified in any sense the accelerated price inflation during this period, particularly in view of profit margins and aggregate profits. Consumption, supported so substantially by wages, had certainly not been excessive, but rather has been deficient, during the past 2 years, by economic equilibrium tests.

But let us assume for the moment—contrary to my own view—that the relative trends in wages and salaries and productivity during 1966–1968 "caused" or even "justified" the accelerated price inflation. In that event, this happened, not because the rate of advance in real wages and salaries was too high in terms of any equilibrium model for reasonably full use of our potentials, but rather because the rate of productivity growth dropped abysmally. And this happened precisely because of the abysmal decline in the real rate of economic growth coupled with the election (desirable in itself) to translate this into less efficient utilization of the employed labor force rather than into more overt unemployment. Of course, such inefficient utilization is a form of concealed unemployment.

Under these circumstances, how wrong and upsidedown it is to try to stop this kind of cost-push inflation by further repressive measures, designed to reduce still further a seriously inadequate rate of real economic growth.

Further, my basic position is that policies designed effectively to achieve a stable and optimum economic growth would in the long run yield less net price inflation than result from erratic ups and downs in the real economy, rapidly changing labor and business expectations, and general uncertainty. The evidence to date on this seems fairly clear. But even if the evidence were less conclusive or more arguable on rational grounds, we should choose the certain benefits of steady and optimum economic growth and minimal unemployment, instead of committing ourselves to a theory as to the cause of inflation which cannot be squared with what has been happening.

The entirely erroneous proposition that tight money and rising interest rates serve admirably to help contain inflation is essentially allied with the erroneous idea (discussed above) that policies inimical to optimum economic growth and conducive to excessive unemployment help to contain inflation. Consequently, the analysis which I present immediately below is essentially similar in method to that which I used in discussing the inflationary problem generally.

As shown by my *Chart 19*, during the period 1955–1968 viewed as a whole, the average annual growth in the nonfederally held money supply was only 2.5 percent, and the average annual real growth rate in total national production was at the deficient rate of 3.8 percent. I believe that there was a strong relationship between the deficient growth in the money supply and the inadequate economic performance, but I will not elaborate upon this particular point, especially because I believe that too much weight has been attached to monetary policy in the aggregate in this particular connection. Theoretically, and perhaps practically also, a more or less rapid growth in the money supply might affect the level of prices considerably, but should not affect the real trends in production and employment if economic equilibrium were maintained in the fundamental allocation of resource and in income distribution, which can be achieved either at a more or less rapid growth in the nonfederally held money supply.

Nonetheless, what I have just said does not apply to extreme cases. It seems perfectly clear that the extremely low growth rate in the money supply during 1955–1957, and again during 1958–1960, was intimately associated with the recession of 1957–1958 and the minirecession in late 1960 and early 1961. It also seems abundantly clear that the extraordinarily low growth rate in the money supply during 1955–1966 was an important factor in initiating the extremely low real economic growth rate during 1956–1967 and the unsatisfactory average annual rate during 1966–1968. The relatively more rapid rate of growth in the money supply during 1957–1958 and during 1960–1961, and again during 1962–1965, appears to have been conducive to more favorable trends in the real rate of economic growth. The rapid expansion of the money supply during 1966–1968 seems clearly to have helped prevent the very serious deterioration rate of economic growth during 1966–1967 from being continued over a longer period of time. On net balance, in a long-term perspective, it seems quite clear that the monetary policy has been much too tight, and that a relatively liberal monetary policy is highly conducive to satisfactory economic growth.

More seriously, the monetary policy has worked powerfully against economic equilibrium, because it has helped to reallocate resources in directions bearing no relationship to economic equilibrium, and in many cases quite destructive of it. The tightening of the money supply has had practically no effect upon the relatively excessive investment booms in plant and equipment, because those indulging in these booms are not greatly affected either by general shortages of credit or by rising interest costs; they finance mainly out of retained earnings and out of the price structure. On the other hand, a better rate of economic expansion in other important sectors, or, more generally, a relatively larger ultimate demand composed of both private consumption and public demand, would have been much more conducive to economic equilibrium at steady and optimum growth, and these developments have been very harshly impeded by both tight money and rising interest rates.

Most important of all, in the context of the argument that tight money and rising interest rates restrain inflation, let us look at the empirical evidence. The extraordinarily contraction in the growth rate of the money supply during 1955–1957, while it impacted severely upon the real rate of economic growth, was accompanied by a 3.5 percent average annual rise in consumer prices from 1956 to 1957. The greatly expanded growth rate in the money supply during 1957–1958 was accompanied by a reduction in the rate of consumer price inflation to 2.8 percent. During 1958–1961, there was throughout an inverse or negative correlation between the trends in the money supply and the rate of consumer price inflation. During 1962–1965, a sustained and relatively rapid expansion of the money supply was accompanied by remarkable price stability. During 1955–1966, a very sharp contraction in the rate of growth of the money supply was accompanied by a very rapid acceleration of the rate of price inflation. During 1966–1967, the money supply expanded about three time as fast as during 1966–1967, but the rate of consumer price inflation was slightly lower. During 1967–1968, the rate of expansion of the money supply was the same as during 1966–1967, but the rate of consumer price inflation was tremendously higher.

Viewing these relative trends in an adequate time perspective, it appears to be clear that excessive restraints upon the growth of the money supply worked toward more price inflation in the long-run for practically the same reasons that excessive restraints upon real economic growth and employment expansion worked in the long run toward more net price inflation.

Beyond all this, the almost unbelievably erratic changes in the rate of growth of the money supply over the years represents an attempt at "fine tuning" which is utterly impractical, and really indicative of a wayward and thoughtless long-range monetary policy, and general economic policy as well.

Relevance of foregoing discussion to housing and other real estate investment

The foregoing discussion of the problem of inflation is critically relevant, as I have suggested above, to those portions of the pending Bill which deal with housing and related aspects of real estate investment. If the purpose of the Bill (or in any event, its consequences, as I shall show) is to curb certain aspects of housing and related real estate investment in the desire to curb inflation, the remedy is horribly out of line with the purpose, for reasons I have already stated. Shortages in housing and in related or supportive real estate investment manifestly exert a strongly inflationary impact upon the costs borne by those who live in houses, whether they buy or rent. The excessive idleness of plant and manpower today, and the larger excesses which I believe are inevitable in future unless the rate of real economic growth is accelerated, are inflationary for reasons which I have already stated. The corrosive effects of inadequate housing upon human beings and their productivity is inflationary.

But even if we needed to restrain the overall rate of economic growth in order to impede inflation—which I do not believe for reasons already stated—that would be no reason for distorting the economic equilibrium further, neglecting all human social considerations, and directing repressive efforts against the rescue and renewal of our urban areas which depend fundamentally, and by common consent, upon enormous acceleration of housing and related or supportive aspects of real estate investment. If we did in fact need to repress, beyond the effects of current measures, the current overall levels of economic activity, we should by all means cut back even further on some lines of expendable or excessive activity than the current Bill proposes to do. We should correspondingly redirect vastly more of our economic activity toward the great priorities which I have just mentioned. This further fortifies my arguments set forth above, in favor of changes in many provisions of the current Bill. It illustrates the inseparable relationship between these provisions and the housing and real estate provisions, and thus justifies my extensive treatment of these other provisions. I now turn to specific analysis of those provisions of the Bill which bear upon housing and related aspects of real estate investment.

The Role of Housing and Commercial Construction in the National Economy General comments on relevant portions of the current Bill

There is no proposition more generally accepted than the proposition that, even in terms of human and social interests alone, our top domestic problem is the rescue and restoration of our urban areas. Toward this end, the Congress, even as of now, has legislated the objective of—although it has not appropriated the funds for—many billions of dollars on an annual basis, looking a decade or so ahead. Broadly speaking, these efforts are directed toward sustaining an annual volume of home construction in the neighborhood of considerably more than twice the current level.

In recognition of this, there is a general belief that the current Bill as now written does not include housing in the repressive or restrictive changes in the tax laws relating to other aspects of real estate investment. This is incorrect. As I shall show in detail, various provisions of the Bill would be extremely hurtful to housing itself. They would thus run directly counter to the well-night universal view as to the nature of housing needs, and even counter to some of the most important programs of the Congress and the Executive Branch.

Even if what I have just said about the provision of the Bill with respect to housing were incorrect—and they are correct—an attempt to classify various types of housing, maintaining current tax benefits for some types but withdrawing it for others, or maintaining these benefits for new construction but withdrawing it from housing after transfer, is utterly unrealistic. The entire housing market and supply (with perhaps some exceptions at the top of the luxury market) is a seamless web. Construction of almost any type of housing adds to the supply and reduces the shortages. Construction of any type of housing helps to meet the great problem of housing's contribution to needed economic growth and employment in future. Construction of housing for middle-income groups exerts some upward shifting of housing use, and thereby reduces the pressures upon occupancy of unsatisfactory housing, as well as ameliorating somewhat the need for the construction of low-cost, low-rent housing, which involves the largest public costs.

In addition, it is most unrealistic and damaging to draw a sharp dividing line between housing and other forms of commercial construction or investment in real estate, leading to greatly differential treatment of the two, as the Bill in its present form does. Cities are not made up of houses alone. Urban deterioration is not limited to housing. Community facilities, stores, quarters for the occupancy of those rendering professional services, and even some aspects of industrial construction in urban areas, are intimately connected with the solution of the housing problem. They are intimately connected with employment opportunity. Many of these facilities and services are incorporated in the same structures as the housing units.

Moreover, if we are to develop the large-scale ventures which are essential to successful urban renewal, we need increasingly, and on an enormous scale, to promote the entry of large-scale enterprisers who combine housing ventures with the other types of ventures which I have mentioned. It would thus be giving with one hand and destroying with the other hand, if tax legislation were enacted which left the housing aspects of current tax legislation where it now is (which the current Bill does not even do), but draws in the reins sharply on these other types of ventures.

Similarly, there is little or no merit in the argument that, if real estate investment other than housing is further curbed, there will be more investment funds available for housing, and especially low-cost low-rent housing. In the first place, as I have already indicated, the funds now going into these other aspects of real estate investment are too small, not too large, and this even works against adequate housing development and urban renewal. In the second place, even if funds were turned away from these nonhousing forms of investment, they would not go in large measure into housing, and certainly not into low-rent low-cost housing, the stimulation of which is advanced as main reason for turning funds away from these other forms of investment. Practically all of the funds going into low-rent low-cost housing are underwritten almost completely in one form or another by the Government, in small part by direct subsidies, and predominantly by effective guarantees of the private capital flowing into such undertakings. It is therefore chasing a will-o'-the-wisp to hope that the further curbing of these other forms of investment would be of measurably significance for low-rent low-cost housing. To any extent that it might be feasible to transfer investment funds now going into other purposes into housing in general, or especially into low-rent low-cost housing, the sensible approach, as I have proposed earlier in my testimony, is to make the curbs on those types of investment which are now expendible or excessive even more stringent than they are in the Bill as now drawn. I predict that, if the Bill is enacted in its present form, a large portion of the funds now flowing into real estate investment other than housing will (a) flow into forms of investment of far lower priority than either of these two types, or (b) stagnate, thus contributing to more idle manpower and other productive resources.

To indicate the magnitudes at stake, I have estimated in a number of studies, some of which have previously come to the attention of this Committee, that close to half of the total employment problem which will be generated by technological displacement in some industries, and by population growth, during the decade ahead can be solved within the ambit of adequate programs of urban renewal, focusing sharply to be sure upon housing, but necessarily including these other types of related or supportive ventures. Aspects of the basis of these conclusions are indicated on my *Charts 3, 4, 22, and 23*, already discussed.

I am as fully aware as others that some of those who have engaged in real estate investment have taken indefensible advantage of the existing tax laws, to the effect that their tax payments have been excessively reduced, or even reduced to zero. I desire, as much as anybody else, to remedy these evils, and commend the purpose of the House and of this Committee to do just that. But in sober realism, we must now throw out the baby with the bath. All aspects of national tax policy must look at the whole picture, and must recognize that any specialized or *ad hoc* tax policy which is "liberal" enough to accomplish its basic purpose will allow enough room to permit a small percentage of those in the relevant line of endeavor to get away with excesses. Indeed, even tightening up of tax policy along the lines set forth in the current Bill would probably still leave room for some of the powerful, skillful, and well-advised to get away with more than they should, even while these provisions would cripple or destroy hundreds of thousands of essential and useful enterprisers in housing and related aspects of real estate development who are not getting away with anything.

This does not mean that I do not favor appropriate measures directed against those who are getting away with more than they should. I certainly do. The most constructive and useful measure in this direction is the vigorous limitation on tax preferences (LTP), which, as I have indicated above, should be strengthened well beyond the Bill in its current form.

The critically deficient rate of activity in housing and related real estate investment

I now turn to more specific factual illustrations bearing upon what is happening to housing and related aspects of commercial construction. First of all, my *Chart 20* calls the attention of this Committee to the alarming decline in housing starts during 1969. The annual rate, seasonally adjusted, has declined month by month from 1,845 thousand units in January to 1,314 thousand units in June, a staggering decline of about 28.8 percent. This drop is continuing, and the end is not yet. Under these circumstances, I cannot understand why proposed legislation should now take the risk, even if it did not import the certainty, of augmenting this alarming downward movement by removing existing tax incentives. These incentives, in the view of all knowledgeable people, have certainly been stimulative on net balance, even if the stimulation has involved some improper costs as against enormously larger net advantages. Even those not certain that the proposed changes in the Bill would be as damaging as I and other knowledgeable people appraise them to be, it seems to me entirely unwise to introduce into the housing picture any elements of uncertainty at this time, or in the near future.

If we should take this unfortunate course how could we come within hailing distance of more than two million housing starts per year, redress the current conditions and trends within our urban areas, remove the slums within which live at least one-sixth of our people, or alleviate the excessive housing costs being borne by so many other millions of our people, due in large measure though not entirely to the inadequate growth in the housing supply?

My *Chart 21* serves two purposes. It depicts on a long-range basis the role of housing and commercial construction combined in the national economy, and also depicts the ominous relative decline since 1955. In 1955, these two elements of investment (investment in housing and investment in commercial construction) came to 6.41 percent of GNP. Even this was lower than the 7.13 percent reached in 1950. But by 1968, with declines in most years since 1955, the ratio was only 4.35 percent. It was only 4.39 percent in the second quarter of 1969.

Measured as a percentage of total private domestic investment, the ratio of investment in housing and commercial construction to the total was 40.8 percent in 1954, and 39.4 percent in 1958. In 1968, it was only 29.8 percent, and decreased further to 29.0 percent in the second quarter of 1969.

My *Chart 22* approaches the same problem from another perspective. It shows that, during 1961–1968, measured in 1967 dollars, the average annual rate of growth in our Gross National Product was 5.2 percent; in personal consumption expenditures, 4.9 percent; in private domestic investment, 6.2 percent; and in Government purchase of goods and services, 6.0 percent. Again broadly speaking, I think that this represented a reasonably good balance in the long-run, except that the private domestic investment sector did not include nearly enough housing and related real estate investment. Instead, it included far too much investment, relatively speaking, in producers' durable equipment and new plant and equipment. (These separate categories overlap considerably, but are not identical). The average annual rate of growth in producers' durable equipment was 9.9 percent; in new plant and equipment expenditures, 7.5 percent; in commercial structures 4.9 percent; and in nonfarm residential structures only 0.5 percent. The relatively excessive rates of advance in the first two categories was due to excesses during subperiods of very strong and advancing prosperity. This contributed greatly to inflationary pressures, and then to severe cut-backs from time to time which impacted adversely upon the overall economy. These excesses were very substantially due to excessive tax cuts and concessions for these two categories, and also to excessive price-profits trends in many key industries. In vivid contrast, the growth rate in commercial structures relative to need lagged, and the growth rate in nonfarm residential structures was lamentably low. This does much to explain one of our top domestic problems, urban deterioration. Our cities are becoming obsolescent because they are not being renewed, and these two types of activity are at the heart of such renewal.

By this pragmatic test, it appears clear that the housing and related categories, so inseparably connected with urban life, have had incentives which have been deficient rather than excessive. I am not overly impressed with theoretical or mathematical displays that some tax concessions or other benefits are either too large or too small, or with spectacular showings that somebody may be "getting away" with something (although this should be appropriately remedied), or with tenuous attempts to delineate causes and effects with precision. It remains an irrefutable *datum* that we have been moving dangerously too slowly in the residential and construction areas which I have identified. And because adverse changes in the rules of the game always produce unsettling effects which cannot be exactly measured—not only economic and financial, but also psychological—I reach the conclusion that it would be unwise now to tamper adversely with the tax treatment of these two vital sectors. The Congress recently approved, during a Democratic Administration, a tremendous long-range housing and urban renewal program, at great cost to the Government. It appears that this program has also been approved by the current Republican Administration, or at the very least by the HUD Administrator. Why, then, should we retard with one hand what we are attempting to stimulate with the other?

The immense needs of the future

These conclusions are reinforced by looking to the future. My *Chart 23* depicts balanced growth rate goals for important sectors of the economy Aside from matters of detail, these goals are consistent with those put forward by many other private and public research organizations, and are explicit in the approved programs of the Government itself. Projected from 1967 to 1977, the indicated goals are an average annual rate of growth of 5.3 percent in GNP, and fairly similar rates of growth for the main components thereof. Considerably lower GNP goals would not appreciably affect the relationships, which are the real significance of the exercise. Compatible with these major-component projections, the average annual rate of growth projected is 6.5 percent for total fixed investment; 4.1 percent for producers' durable equipment, 5.9 percent for commercial structures; and 11.2 percent for residential structures. The higher-than-GNP rate of growth for commercial structures, and the extraordinarily high rate of growth for residential structures, are designed to compensate for the lag in these two areas during the past years under review, to make the relative growth rates in these two sectors compatible and mutually reinforcing, and to fulfill objectives for urban renewal almost universally shared. They are, for example, entirely consistent with recent housing and urban renewal legislation, and in fact are derived largely therefrom.

It must be perfectly clear, combining pragmatic examination of these goals for the future with a pragmatic examination of the record during the past eight years, that we now cannot afford to inject into urban renewal any factors which would be repressive rather than stimulative, and induce uncertainty instead of legitimate confidence.

Relevant aspects of the Federal revenues and expenditure picture

Let us now turn to the Government revenue and expenditure side of the problem. My *Chart 24* shows the value of depreciation and depletion, in dollar terms, as expressed in corporate income tax rates. In 1966—and the choice of any other year would yield practically the same results—the total value of depreciation and depletion allowances so expressed was 43.1 billion dollars. Of this value, 45.7 percent related to manufacturing; 22.5 percent to transportation, communication, and electrical, gas, and sanitary services; 7.9 percent to wholesale trade; 7.2 percent to the service industries; and only 5.8 percent or 2.5 billion dollars to real estate. Taking into account also that these data relate to all depreciation and depletion, and not merely to that portion affected by special concessions or allowances, it must be manifest that the absolute and relative size of any recoupments the Government might attempt through tampering with depreciation allowances in the case of real estate might be making a mountain out of a mole hill. In any event, it would yield very little additional revenues, relative to the positive arguments which I have set forth against taking this risk.

It is also revealing to look at the picture with respect to the dollar value of Federal subsidy programs, as distinguished from tax concessions in one form or another. My *Chart 25* does this. For the fiscal years 1964-1969 inclusive, the average annual cost of the specified key subsidy programs of the Federal Government came to 6.7 billion dollars. Of these, 57.7 percent went to agriculture; 12.7 percent to health, education, welfare, and labor; 10.5 percent to air transportation; 8.9 percent to maritime; 7.3 percent to nonspecified categories; and only 2.9 percent to housing. In the fiscal year 1969, with the total subsidy figures estimated at 8.2 billion dollars, only 6.8 percent went to housing. Even in this year, the allocation to housing was strikingly small. And yet, its elevation from the five-year average of 2.9 percent to 6.8 percent demonstrates in itself the great effort being made to move forward more rapidly in this critical area. It thus negates the advisability of taking one step forward and another step backward by any distinctly adverse action in this sector.

The role of housing and related real estate in total fixed investment

My *Chart 26* is designed to portray the immense importance of investment in residential and commercial structures, relative to total fixed investment. This facilitates contrast between these magnitudes and the tiny share of tax and subsidy benefits received by the housing and real estate categories, as already portrayed. In 1961, residential and commercial structures preempted 41.9 percent of total fixed investment. By 1968, this had dropped to 31.1 percent, another dramatic illustration of a gravely deteriorating situation. The goals for 1977, to which I have already referred in another connection, contemplate that residential and commercial structures should preempt an estimated 41.0 percent of total fixed investment, coming up close to the 1961 ratio, but running very far above the critically depressed 1968 ratio. Looking at these ratios in conjunction with my earlier data reveals (1) how desperately little Federal help these types of activities have been receiving, by way of tax and subsidy assistance, relative to their magnitude and vital importance, and (2) the basic goals set are incompatible with adverse treatment of housing and real estate at this time.

The lowly financial rewards to real estate

My *Chart* 27 should dispose of any erroneous notion that the real estate industry is "in clover", and should help to dispel the idea that the broken desire to take action against the relatively few who have been getting away with tax-avoidance excesses should be translated into new tax action which would hurt and penalize the industry as a whole, as it labors already under the tremendous burden of rising interest costs and other disadvantages which I have already depicted, and finds itself unable to rise to the challenge of vitally needed expansion of activity. In 1965 (latest year available) net income per the Internal Revenue Code, measured as a percentage of net worth, was only 3.5 percent for real estate, the lowest of the eight specific categories shown on the chart. It was 8.2 percent for all industry. It was 4.4 percent even in agriculture, 6.0 percent in finance and insurance, 8.2 percent in trade, and 10.3 percent in manufacturing. Net income as stated on books of account, as a percentage of net worth, was 4.9 percent in the case of real estate, again the lowest among the eight categories. It was 10.0 percent for all industry, 8.3 percent in finance and insurance, 9.6 percent in trade, and 11.7 percent in manufacturing.

Another vital factor shown on the chart is the ratio of long-term debt to total assets. This indicates the almost unique extent to which real estate has been affected adversely by tight money and rising interest rates. This ratio was 48.4 percent in real estate, contrasted with 12.2 percent for all industry. It was only 2.9 percent in finance and insurance, 10.8 percent in trade, and 13.7 percent in manufacturing.

The impact of rising interest rates

There is one remaining point which I desire to call to the attention of the Committee, involving another tremendous liability under which the home building sector has suffered. My *Chart 28* shows that, comparing the average for 1952 with December 1968, the mortgage yield on new FHA-insured homes rose from 4.29 percent to 7.13 percent, an advance of 66.2 percent (it is much higher now). To be sure, as shown on the chart, other types of bond yields and interest rates have risen far more. Nonetheless, as we all know, the home building industry has been hurt far more seriously by tight money and rising interest rates than almost any other sector. This is because the Government, as well as business in general, finances only a small proportion of its outlays with borrowed money, while the home building industry and home owners, almost by definition, do just the reverse. The adverse impact of rising interest rates upon urban commercial construction is also very great.

It is in fact a gross understatement to say this: The increased costs imposed upon the home building industry and upon home ownership by rising interest rates have been much greater than the net value of benefits conferred in the form of Federal tax concessions and subsidies. This is another example, and a most serious one, of national policies moving in opposite directions simultaneously.

I have very recently made the following estimate: From 1952 through 1968, the *average* interest rates on all 1–4 family nonfarm home mortgages (not the interest rates on new loans, which rose more than twice as much) rose *43.7 percent*. During 1953–1968 as a whole, this imposed an additional interest burden of *17.4 billion dollars*, compared with what interest costs would have been if they had remained at the 1952 level. Even if interest costs are soon stabilized or somewhat reduced, these costs will continue to spiral upward until the interest rates on new borrowings are no higher than the average interest rates on existing loans. And this will *not* come to pass in the foreseeable future. As I have already indicated, the toll imposed upon housing and other real estate investment by rising interest rates exceeds many, many times the benefits conferred upon these lines of endeavor by all tax concessions to them in their current form.

Summary of foregoing housing and real estate portions of testimony: relevance of LTP

In summary of this phase of my discussion, our urban areas are in deep and increasing trouble. They must be resuscitated and renewed. Investment in residential and commercial structures, on a vastly expanded scale, is essential to these purposes. Although the Federal Government has asserted the high priority of these purposes, it has not made manifest that high priority in the relative tax and subsidy help which it has extended to residential and commercial investment.

On the revenue side, any recoupment which the Federal Government might achieve through even less favorable treatment of these sectors would be a mere bagatelle, compared with the potentials for recouping revenues in other ways.

Further—such action would deal a further blow to sectors which imperatively requires even more encouragement than they have been receiving.

In saying this, I stress again that I am entirely in favor of rigorously limiting total allowable tax preferences (LTP), so that none of those in housing and other real estate or elsewhere shall continue to avoid their decent tax responsibilities. But as I have said, the proper way to get at this problem is through LTP, not by placing further *ad hoc* curbs upon nationwide endeavors which need additional stimulation.

It should be noted, in this connection, that the current Bill withdraws accelerated depreciation from some industries and not from others, presumably on the ground that some industries should be further restrained and that others—such as trucking and airlines—should not be so restrained. But insofar as this withdrawal of accelerated depreciation is designed to get at individuals or business entities which are "getting away with something", it is manifest that such practices may exist in various industries, regardless of whether or not they are deemed to be in need of further stimulation or further restraint. This in itself indicates that the withdrawal of accelerated depreciation is a blunderbuss and in fact erroneous tool for getting at those who are "getting away with something", in that it disregards the larger question of the condition of the industry affected thereby, and whether such industry needs further stimulation or further restraint. And if the withdrawal of some current tax benefits from housing and other real estate investment is predicated upon the notion that they should have imposed upon them further restraints, while other industries should not, this notion can find no support in actual economic, financial, or public policy considerations. Nor can it be reconciled with the mandate of our great national priorities.

I therefore respectfully submit that it would not be desirable to reduce on net balance the help and encouragement which housing and other aspects of real estate investment are receiving from the Federal Government. The generally laudable purpose to close what are some loopholes in this sector should not be permitted to carry the day, in view of the far more important damage and dangers which would flow from any such course of action. LTP, strengthened even beyond the provisions of the Bill in its present form, is the proper approach to this generally laudable purpose.

Detailed discussions of specific provisions of the bill relating to housing and nonresidential construction

The larger issues

I now come to my analysis and conclusions with respect to those provisions of the current Bill which bear directly and specifically upon housing and nonresidential construction.

But before proceeding with this phase, I want to warn against the tendency of some of those involved in these matters to bog down in what I regard as overly technical discussions of details, bordering at times upon the captious. These specific provisions of the Bill, technical though they are, present profoundly important issues of general economic, financial, and social policy. I therefore express my profound conviction that the types of materials which I have thus far presented in this testimony go beyond and rise above the technical details, and constitute definitive reasons for not going ahead with the provisions of the current Bill relating to housing and nonresidential construction.

Putting this in another way, no mere permutations of these technical provisions can, in my view, take the place of reconsideration of the fundamental premises of policy upon which these provisions rest—premises which I believe to be demonstrably mistaken. To the extent that there is large merit in what I have thus far submitted throughout this testimony, the problem of correction of the detailed provisions of the Bill relating to housing and nonresidential construction is not a matter of detail. These corrections cannot be effectuated through mere refinements, compromise, or hair-splitting.

Another basic reason why I do not want to get too much into the technicalities is that this Committee has been and will be benefited greatly by the technical discussions of many other witnesses. Some of these witnesses may be more conversant with these technical aspects than I am, and most of these witnesses may not deal as extensively as I do with the larger issues toward which my testimony is primarily addressed.

Nonetheless, I feel it incumbent on me to proceed with some, or even considerable, discussion of the detailed and technical provisions of the Bill relating to housing and nonresidential construction. But even in the course of such discussion, for purposes of clarification and completeness, I will again discuss some of the larger issues, and I hope that this will not prove too repetitive of what I have said earlier in my testimony.

Provisions of the Bill directly affecting both housing and nonresidential construction

The current Bill makes no change in the presently allowed double declining balance method for depreciation of new housing, and this has created the impression in some quarters that the Bill does not affect investment in housing at all. Nothing could be farther from the facts. The current Bill contains a number of provisions that are directly injurious to both housing and nonresidential construction. These are listed briefly.

Used buildings (sec. 521).—For all used buildings acquired after July 24, 1969, the new owner would be required to use straight line depreciation instead of the presently allowable 150 percent declining balance method.

Recapture (sec. 521).—For all buildings sold after July 24, 1969, the excess of accelerated depreciation over straight-line depreciation as taken by the original owner, is to be taxed as ordinary income (to the extent of the gain occurring upon sale).

LTP and allocation of deductions (sec. 301, 302).—For individuals, the excess of actual depreciation claimed on all real property over the straight-line method is considered a tax preference. Under LTP, tax preferences must be included in gross income to the extent that they exceed 50 percent of economic income. Under the allocation of deductions rule (ADR), deductions are disallowed in the proportion allocable to untaxed preference items of economic income. This provision is especially onerous because it requires that excess depreciation be calculated property by property, and in each year.

Limitation on interest deductions (sec. 221).—Except where interest is incurred in consumption or in a trade or business, the current Bill limits individual interest deductions to investment income plus 25,000 dollars. Since rental of real property on a net lease basis is explicitly denied the treatment accorded a trade or business, owners of real property which they lease on a net basis would be denied interest deductions they can now obtain.

There are some who believe the limitation on interest deductions could be used to disallow interest on a construction loan. Others disagree, feeling that the construction of buildings is a trade or business, not an investment. Be that as it may, the uncertainties in this respect add another disincentive factor which might be serious.

Additional preference item proposed by the Treasury Department.—Treasury Assistant Secretary Cohen, in his statement before the Committee on September 4, proposed that a new tax preference item affecting real estate be included both in LTP and ADR. The new preference is the excess of interest, taxes, and rentals paid over receipts (if any) during construction.

Adverse effects of provisions affecting both housing and nonresidential construction

The issue of allowable types of depreciation is central to all provisions of the current bill affecting housing (and other real estate investment), except for the limitation on interest deductions. And even with this provision, as with the new tax preference items proposed by the Treasury, the tax issues are similar to those raised by the tax treatment of depreciation deductions.

The tax effect of accelerated depreciation is to postpone ordinary taxable income from the early years of a project's life, when depreciation deductions are higher than they would be otherwise, to the later years, when these deductions are lower. (Immediate deduction of interest and other expenses, in years when reported income from the investment project is not large enough to cover them, has a similar effect of postponing taxable income.) Postponing taxable income of course postpones taxes, so the effect of accelerated depreciation is an interest-free loan as against straight-line depreciation. Accelerated depreciation is thus more favorable than straight-line depreciation.

But this does not mean that accelerated depreciation is an inequitable tax concession, even in the narrow sense where equity depends solely upon having taxable income equal currently realized economic income. Equity in this narrow sense depends upon having allowable depreciation deductions equal the actual decline in the economic value of a property, and determining the actual decline is a very difficult question of fact.

Assuming for the moment (although I seriously challenge) that some of those who have studied the problem are right in their finding that the actual economic or value depreciation of office buildings, and even of some other real property, is less rapid than straight-line, the primary consequence of allowing accelerated depreciation (under this assumption or finding) is that the postponed ordinary taxable income can be taken at a later date as a capital gain, taxed at favorable rates, instead of as taxable future ordinary income. This is done by selling the property, at some later date, at a price which capitalizes the ordinary income expected to accrue after that date. The current Bill is apparently designed to correct this alleged inequity (in the narrow sense of equity) of the present tax laws. But if the finding is incorrect (which I think to be the case), if the decline in economic value actually does occur at the rate of accelerated depreciation, then the capitalized value of postponed ordinary income only offsets what would otherwise appear on an investor's tax return as a capital loss, and it does not in any way reflect the conversion of ordinary income to capital gains.

In any event, the assumptions and findings which I deem to be so highly questionable (and certainly not supported by adequate empirical testing), have no direct bearing upon the various provisions of the current Bill which affect housing. The most important of the provisions affecting housing are the elimination of accelerated depreciation for purchasers of used buildings, and the recapture provision (sec. 521). These provisions deny the housing investor most of the advantages of the double declining balance method for depreciating new buildings, even though those who have made the findings with which I disagree do not purport to show that accelerated depreciation is inequitably rapid for housing.

The effect of these two provisions on an investor in *new* housing is double-barrelled, because in two ways it makes the tax treatment of investment in new housing much less favorable than the tax treatment of other investments. First, any time this investor wants to sell his building, the price will be depressed because the buyer cannot take advantage of even 150 percent declining balance depreciation. Second, if the original investor does sell anyway, the Bill requires that any capital gains, up to the excess of accelerated over straight-line depreciation, be taxed as ordinary income. This means that only the postponement of ordinary taxable income, but never its conversion to capital gains, will be possible under the new law. This change might conceivably be desirable if it could be shown conclusively that accelerated depreciation as to housing and other real estate investment is always excessive, and that true economic income were being converted into capital gains. But to my knowledge there has been no such showing as to housing, nor do I believe that such showing can be made. Further, it is probable in many cases that the gain being "recaptured" was never ordinary income in the first place, but rather a wise speculation on the value of a particular capital asset.

I have stated earlier in my testimony that some tightening of the tax treatment of capital gains is desirable, and this conclusion might seem to contradict what I am saying here about recapture. However, it is important to note that the recapture provisions of the current Bill apply only to investments in housing and other real estate, not to capital gains generally. This is why I find these recapture provisions so unwarranted, at a time when housing and other real estate investment should be stimulated relative to other kinds of investment, not depressed.

The combined effect of recapture and of straight-line depreciation for all acquisitions of used buildings is to make investment in residential construction much less liquid that it is presently. Since housing generally has such a long life, any decrease in liquidity as apt to depress severely investment in housing, and this is patently undesirable. It is recognized that rapid turnover is a problem, and that present phasing out of recapture may be viewed by some as inadequate to prevent unduly rapid turnover. In that case, full recapture of excess depreciation could be extended to five years, with the recaptured percentage of the excess depreciation declining by one percent per month for 100 months thereafter.

Recapture and straight-line depreciation of used buildings are not the only provisions adverse to housing. The limitation on tax preferences (sec. 301), the allocation of deductions (sec. 302), and the limitation on interest deductions (sec. 221) also affect housing (and other real estate investment) adversely. LTP prevents investors in housing from taking the full benefit of accelerated deductions to the excess of accelerated depreciation over straight-line deprecia-
preferences the taxpayer may have) exceed 50 percent of economic income. ADR

requires that investors in housing (and other real estate) allocate some of their deductions to the excess of accelerated depreciation over straight-line depreciation, leaving lesser amounts to be deducted from income subject to taxation, and this too reduces the benefits that can be obtained from accelerated depreciation. Although these provisions would make investment in housing less attractive to most investors, I believe, as I have explained, that they are the proper way to prevent gross abuse of the tax stimuli favoring investment in housing. However, I do not agree with the Treasury that interest and taxes paid during construction of real property improvements should be included at this time as a tax preference. My reason is that the use of this practice has received much less scrutiny than the use of accelerated depreciation, and it is not clear at this time that treatment of these interest and tax costs as a preference item is justified. It should also be noted that the Treasury proposal discriminates against housing and other real property, in that other kinds of property are not subject to similar tax treatment.

Although I do favor LTP and ADR, as I have explained, I want to emphasize that their application to housing (and other real estate investment) will have an adverse effect. For this reason it is even more important that the other provisions of the Bill damaging to housing not be adopted.

Retroactive features of the bill, and some other technical problems

Before leaving the subject of housing, I should like to point out some retroactive features of the Bil in its current form, and also comment on one other technical problem.

(1) *The following sections of the Bill apply retroactively,* in that they deny certain tax concessions on commitments made before the Bill was reported. This occurs because the income or deduction accrues after the Bill is effective, and thus is covered by its terms.

(a) *Sec. 221, limitation on interest deduction.* The problem here is long-term net leases entered into before the Bill was reported. Interest deductions by the lessor may be limited, even though the investor has a long-term commitment. Also, the lessor is not making unreasonably high after-tax returns over the life of the project—the effect of tax concessions, at least in significant part, is passed on to the lessee in the form of lower rental prices than would otherwise obtain.

(b) *Sec. 301 and 302 LTP and allocation of deductions.* Accelerated depreciation of real property is a tax preference for purposes of LTP and allocation of deductions. Even where a transaction has been committed before the Bill was reported, the transactor loses some benefit from accelerated depreciation. The allocation of deductions is most serious, because it hurts all amounts of accelerated depreciation. The LTP only hurts if the taxpayer has excess depreciation amounts greater than his other income.

(c) *Sec. 521, recapture of accelerated depreciation.* Persons who invested in real estate before the Bill was reported may have done so only in expectation of converting some income to future capital gains, and they have offered lower rentals in anticipation of this tax advantage. The rental commitments continue, but the tax advantage is gone.

(2) *The allocation of deductions to untaxed excess depreciation would not operate fairly.* A taxpayer taking accelerated depreciation only postpones taxable income (and perhaps converts later to capital gains, but not as sec. 521 is now written). However, deductions disallowed are lost forever. Therefore, deductions disallowed on account of excess real estate depreciation should be added back to basis cost for purposes of later determining capital gain. (This treatment would correspond to the treatment of that part of excess depreciation which is itself disallowed under LTP).

Provisions of the bill directly affecting nonresidential construction, and their effects

In addition to all the provisions adversely affecting both housing and other real estate investment, there is one very important provision in the current Bill which applies only to nonresidential construction. This provision, in sec. 521, would limit the use of accelerated depreciation by the original owner of new nonresidential structures to the 150 percent declining balance method, instead of the presently allowed double declining balance method. The 150 percent method is substantially slower than the 200 percent (double declining balance) method, and it therefore reduces very substantially the incentives for investment in nonresidential construction.

The reason given for treating housing and nonresidential construction differently is that "Congress [has] expressed its desire to stimulate construction in low- and middle-income housing to eliminate the shortage in this area" (Ways and Means Report No. 91-413, Part 1, p. 166). However, as I have developed in detail earlier in my testimony, it is entirely unrealistic to posit that better housing in a better environment can be achieved by stimulating residential construction alone. Proper community development requires the blending and integration of housing, appurtenant community facilities, and commercial structures. Without the latter, developers may be unable to open up new areas for housing, because no one wants to live where there are no stores, amusements, or other attractions. This is especially true of low-income persons, because they are known to be much less mobile than persons with higher incomes (the two-car family can live where it pleases; the one-car and no-car family cannot).

Within the cities, it is especially desirable to encourage the development of commercial structures, because such building increase the tax base and provide the cities with sorely needed revenues. These revenues are obtained without placing additional tax burdens on urban residents, and they may thus help to stem or reverse the flow of middle-income families away from the cities, allowing a better mixture of income groups in all residential loci.

It should be clear, therefore, that there is no sound basis for limiting the tax advantages of the double declining balance method only to new housing, because proper and full development of the nation's housing requires a correlative stimulus for nonresidential construction.

The need for favorable tax treatment of new nonresidential construction can also be developed from a more general approach, comparing commercial construction with other sectors of the economy (commercial construction is the largest component of nonresidential, nonfarm buildings, and it is the one on which the Bill in its current form concentrates). As my earlier discussion indicates (see again *Charts 22 and 23*), investment in both housing and commercial structures has been growing much less rapidly than other forms of investment, although sound national economic and social policy requires that both of these sectors grow much more rapidly than they have been growing, and also more rapidly than GNP and other major components thereof.

The deficiency in the pace of housing investment is clearly much greater than in the pace of investment in commercial structures, but that is no reason for removing tax advantages from the latter. The present tax advantages for commercial construction are inadequate in terms of our national needs, and they should be strengthened rather than weakened. In this connection, it should be observed that the current Bill places as great an additional burden on investment in nonresidential real estate as it does on investment in producers' durables. The repeal of the investment tax credit, the only provision directly affecting investment in producer durables, is expected to yield 3.3 billion dollars in 1979, when fully effective (projections based on current volume of activity—see H.R. Report 91-413, Pt. 1, p. 16). This is only 5.6 percent of the 1968 investment in this category. In contrast, the reduction in accelerated depreciation on new nonresidential buildings alone is expected to yield 960 million dollars, or 5.1 percent of the 1968 investment in such buildings, and the other tax provisions affecting real estate will certainly increase substantially the tax effect on new construction in this field, although the Committee Report does not give revenue estimates in sufficient detail to determine these effects exactly.

The immediately preceding discourse implicitly assumes that there is merit in the proposition that commercial buildings (if not housing) depreciate (in an economic or value sense) less rapidly than straight line. For reasons already stated, this proposition has nowhere to my knowledge been vindicated, nor do I agree with it. A recent study by Taubman and Rasche,* made available to the U.S. Treasury, may well have attained some influence in directions contrary to those I recommend. My analysis of this study, showing its shortcomings, is attached as Appendix Two.

The foregoing indicates that the current tax treatment of all real estate investment, both housing and nonresidential, is desirable on the general grounds of public economic policy. However, the current Bill is directed more narrowly to the question of tax equity, and it is important that the tax equity arguments be faced

*P. Taubman and R. H. Rasche, "Economic and Tax Deprecation of Office Buildings" (University of Pennsylvania, Wharton School of Finance and Commerce, Department of Economics, Discusson Paper No. 111, January 1969).

on their own grounds, even though I feel that these grounds are not the best grounds for resolving the basic issues of our national needs for accelerated investment in these sectors.

Equitable considerations

It must be emphasized that tax concessions to the real estate industry do not "enrich" real estate investors generally, as shown on my earlier *Chart 27*. Thus, the current tax concessions available to real estate enable lower rents than would otherwise obtain, and stimulate construction, but they do not provide real estate investors generally with inordinate gains. *This indicates that the equity issue may be somewhat specious: investors in real estate generally are no better off after paying their (allegedly) reduced taxes than other investors paying (allegedly) higher taxes.*

The question of equity is thus transformed into a question of resource allocation—is it proper that real estate investments continue to receive the economic stimulus they now receive from current tax provisions? I feel that the materials I have incorporated in this testimony provide an affirmative answer to this question. This analysis is buttressed by the following additional considerations.

Additional considerations

The increasing burden of State and local property taxes weighs most heavily upon residential and commercial construction, and indeed upon the owners and renters of such properties, including average business people and, most importantly, families of low and lower-middle income. Federal tax concessions for real estate thus serve in part to redress the balance, not disturb it (and they are also a way for the Federal Government to ease the plight of the States and localities).

Second, as already discussed, high interest rates are more burdensome to housing and other aspects of real estate investment than to other industries, because these endeavors are much more dependent upon external financing (rather than retained earnings) and upon debt financing (see again Chart 27). These high interest rates, however, are not necessarily a true measure of either the scarcity or the value of capital for investment, but rather they are contrived by Government policy. It is therefore extremely appropriate that tax concessions to real estate be used to offset some of the distortions caused by artificially high interest rates.

Third, most other forms of investment will retain the advantages of shortened guideline lives and accelerated depreciation, and similar treatment of real estate is again a balancing force rather than a disturbing one.

Consideration of these three factors is an application of what is called the theory of second-best. As a general principle, subsidy for one industry leads to inefficient allocation of resources; but this principle applies only when there are no taxes or subsidies for any other industries. Viewed against the background of an established tax structure, containing many different types of taxes imposed by many different jurisdictions, the simple rule that subsidies cause inefficiency can no longer be applied (if it has any large validity in principle). Given the present tax structure, it seems clear that continued Federal income tax concessions for real estate are appropriate. Of course, major changes in other parts of the structure might be desirable, and it might then become desirable also to modify the tax treatment of housing and other aspects of real estsate investment, but that is not a controlling factor at this time.

Another broad class of reasons for applying only with caution the general rule that subsidies, including those in the form of tax concessions, are inefficient is the incidence of external economies and diseconomies. External factors exist which cause the private signals of market prices to register only partially and inaccurately the values of everyone in the economy. Where this happens, collective action to redirect market incentives is appropriate, and special concessions become necessary. The whole field of housing, urban development, and land use is a classic example of external effects, and there are many economists who argue that such concessions for real estate development are in fact necessary for economic efficiency, not inimical to it.

Finally, in a period of inflation, the Federal tax structure (and income taxes generally) imposes an especially heavy burden on investors holding assets with relatively long lives. The problem is the tax treatment of depreciation allowances, which supposedly enable a taxpayer, in determining his income, to deduct from his revenues the amounts that are only a recovery of his initial capital costs.

Taxation is based upon the principle that a dollar is a dollar, whenever it is received or paid, and the owner of property can only obtain depreciation allowances equal to his original dollar cost, even though some of the depreciation is taken many years after the cost was incurred. This means that, in a period of general inflation, the depreciation dollars deducted from revenue, which are supposed to constitute recovery of cost, are worth less (in purchasing power) than those used to construct or acquire the property. The result is that the taxpayer must pay income taxes on funds whose receipt is necessary just to maintain the value (in goods) of his investment (see Table 1).

The first column of the table shows what would happen in some arbitrary future year *t*, on the assumption that there is no change in the general price level. Revenues, costs and taxes are listed, and in this hypothetical example there is a cash flow (depreciation plus income after tax) equal to 15 percent of the assumed value of the property in that year. This cash flow represents both the recovery of the investor's cost and his income from the investment.

TABLE 1.—EFFECT OF INFLATION ON INCOME AND TAXATION OF OWNERS OF DEPRECIABLE PROPERTY

Year zero:			
Price index	100		
Initial cost of property	$500,000		
Year t:			
Assumed price level	100	200	200
Revenues	$180,000	$360,000	
Operating and maintenance cost	120,000	240,000	
Gross return to capital	60,000	120,000	$120,000
Depreciation allowed	30,000	30,000	60,000
Taxable income	30,000	90,000	60,000
Income tax	15,000	45,000	30,000
Income after tax	15,000	45,000	30,000
Cash flow after tax	45,000	75,000	90,000
Current value of property	300,000	600,000	600,000
Cash flow as percentage of current value	15.0	12.5	15.0

Note: All data are artificially constructed for this example.

The second column of the table shows what would happen on the assumption that the price level in year *t* were double that in year zero, owing to inflation during the intervening period. Revenues, current costs, and the current value of the property are double what they would be with the price index at 100. Allowable depreciation, however, is not doubled, so that taxable income and thus income taxes are more than doubled (in this example, income tax is tripled). The result is that cash flow is less than doubled, and cash flow is therefore a smaller percentage of the property's value than it would be in the absence of inflation.

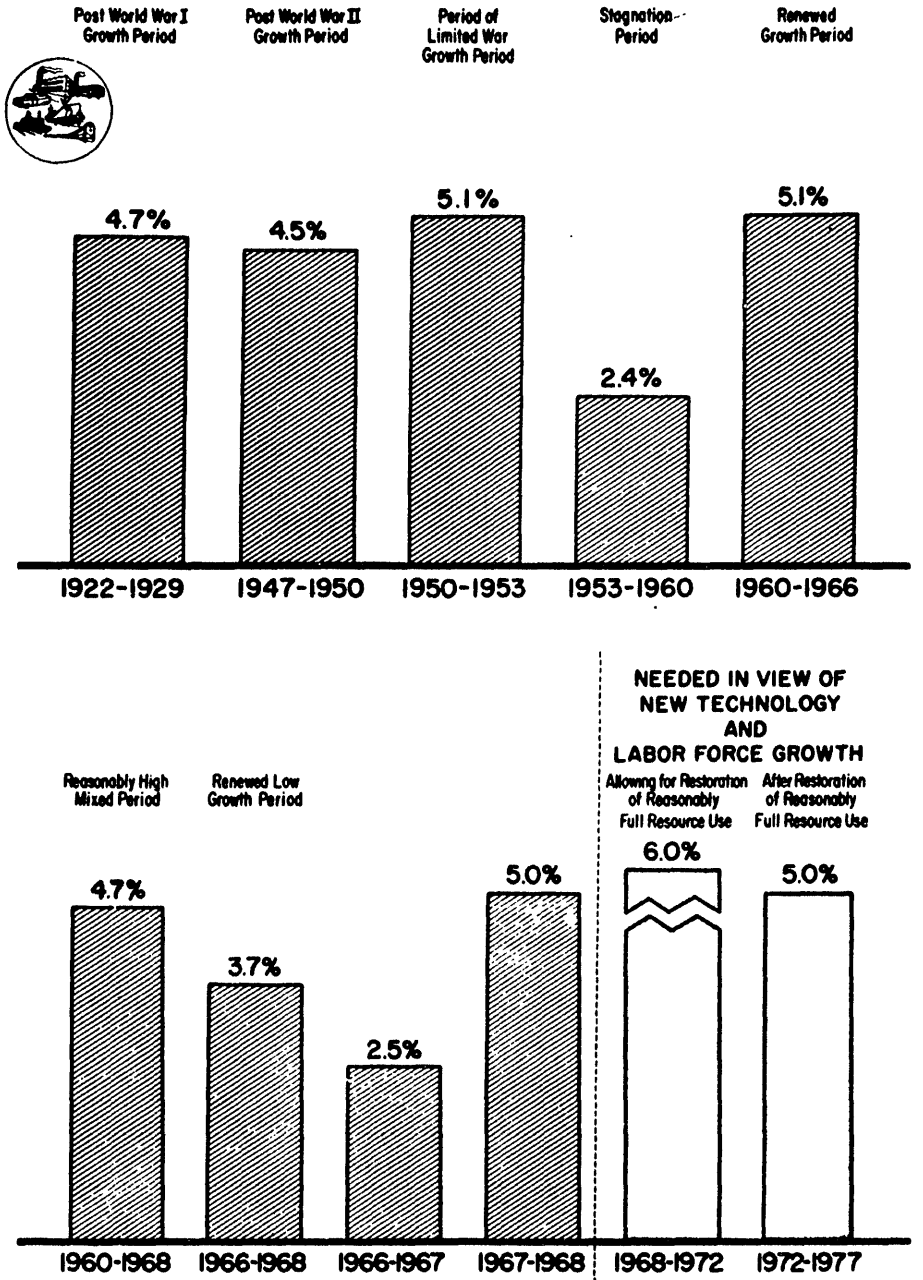
The third column shows how a doubling of the depreciation allowance (in proportion to the amount of inflation) would exactly compensate for the effect of inflation, reducing income taxes to twice the amount that would be collected in the absence of inflation, and thus restoring cash flow to the same percentage of current value as would be obtained if no inflation had occurred.

I do not contend that depreciation, for tax purposes, be calculated on a basis other than recovery in current dollars of initial cost—any change would make administration of the tax laws very much more difficult. However, it should be observed that office buildings have longer lives than most other assets, so the effects described here have a greater impact on them than on, say, investment in producer durables. For this reason one should perhaps make other adjustments in the handling of depreciation for long-lived assets, *and shorter guideline lives plus accelerated depreciation seem appropriate.*

Chart 1

U.S. ECONOMIC GROWTH RATES, 1922-1968,[1/] AND NEEDED RATES, 1968-1977, FOR OPTIMUM RESOURCE USE

Average Annual Growth Rates in GNP, Constant Dollars



1/ 1968 estimates is preliminary.
Basic Data: Dept. of Commerce, Office of Business Economics

Chart 2

COSTS OF DEFICIENT ECONOMIC GROWTH U.S. ECONOMY, 1953-1968 AND 1969-1977

(dollar items in billions of 1967 dollars)

1953-1968

Total National Production (GNP)	Man-years of Employment[1]	Personal Consumption Expenditures	Gov't Outlay for Goods and Services
1953-1968: $ 917.8 1968: 81.8	1953-1968: 38.6 Million 1968: 2.1 Million	1953-1968: $692.8 1968: 73.1	1953-1968: $32.9 1968: -11.7
Private Business Investment (Incl. Net Foreign)	**Average Family Income**	**Wages and Salaries**	**Unincorporated Business and Professional Income**
1953-1968: $192.1 1968: 20.4	1953-1968: $11,459 1968: 1,208	1953-1968: $637.2 1968: 67.3	1953-1968: $79.4 1968: 8.4

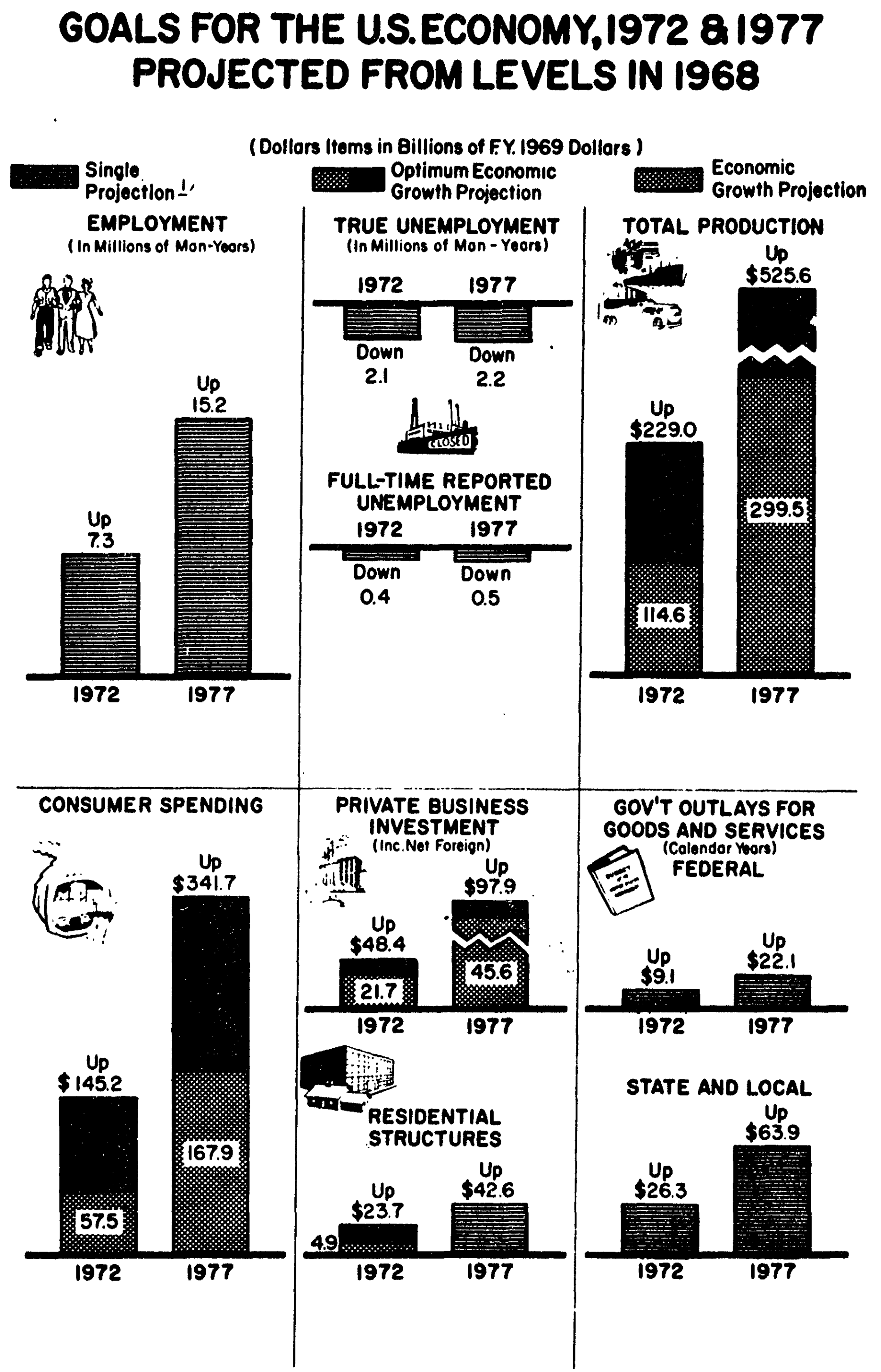
1969-1977

Total National Production (GNP)	Man-years of Employment[1]	Personal Consumption Expenditures	Gov't Outlay for Goods and Services
1969-1977: $1,173.7 1977: 215.4	1969-1977: 31.4 Million 1977: 5.0 Million	1969-1977: $ 764.0 1977: 144.4	1969-1977: $146.1 1977: 27.2
Private Business Investment (Incl. Net Foreign)	**Average Family Income**	**Wages and Salaries**	**Unincorporated Business and Professional Income**
1969-1977: $263.6 1977: 43.8	1969-1977: $ 11,958 1977: 2,349	1969-1977: $ 702.7 1977: 132.8	1969-1977: $ 87.6 1977: 16.6

[1] Based upon true level of unemployment concept, including full-time unemployment, full-time equivalent of part-time unemployment, and concealed unemployment (nonparticipation in civilian labor force) due to scarcity of job opportunity.

Basic Data: Dept. of Commerce; Dept. of Labor

Chart 3



1/ The single projections relate to goals of such high priority that they should not be reduced even if only the lower goals for GNP are attained. In that event, lower priority objectives should be modified accordingly.

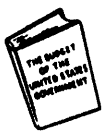
Chart 4

GOALS FOR A FEDERAL BUDGET, 1972 AND 1977, GEARED TO ECONOMIC GROWTH & PRIORITY NEEDS

1969, fiscal year; goals for 1972 and 1977, calendar years

All figures in fiscal 1969 dollars [1]

ALL FEDERAL OUTLAYS



Year	Total Expend. (Bil $)	Per Capita ($)	% of GNP (%)
1969 [2]	186.062	917.01	21.02
1972	226.500	1,068.90	20.61
1977	280.000	1,223.77	20.06

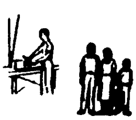
NATIONAL DEFENSE, SPACE TECHNOLOGY, & ALL INTERNATIONAL

Year	Total Expend. (Bil $)	Per Capita ($)	% of GNP (%)
1969 [2]	89.515	441.18	10.11
1972	90.000	424.73	8.19
1977	94.000	410.84	6.73

ALL DOMESTIC PROGRAMS

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	96.547	475.84	10.91
1972	136.500	644.17	12.42
1977	186.000	812.93	13.32

ECONOMIC OPPORTUNITY PROGRAM

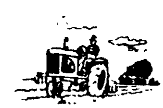


Year	Total Expend. (Bil $)	Per Capita ($)	% of GNP (%)
1969 [2]	2.000	9.86	0.23
1972	3.800	17.93	0.35
1977	5.500	24.04	0.39

HOUSING AND COMMUNITY DEVELOPMENT

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	2.784	13.72	0.31
1972	5.500	25.96	0.50
1977	9.000	39.34	0.64

AGRICULTURE; AND NATURAL RESOURCES



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	8.099	39.91	0.91
1972	12.000	56.63	1.09
1977	15.500	67.75	1.11

EDUCATION

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	4.699	23.16	0.53
1972	16.200	76.45	1.47
1977	32.900	143.79	2.36

HEALTH SERVICES AND RESEARCH

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	10.655	52.51	1.21
1972	14.000	66.07	1.27
1977	20.000	87.41	1.43

PUBLIC ASSISTANCE; LABOR, MANPOWER, AND OTHER WELFARE SERVICES

Year	Total Expend. (Bil $)	Per Capita ($)	% of GNP (%)
1969 [2]	6.280	30.95	0.69
1972	9.500	44.83	0.86
1977	15.100	66.00	1.08

[1] Dollars of purchasing power apparently assumed in President's fiscal 1969 Budget

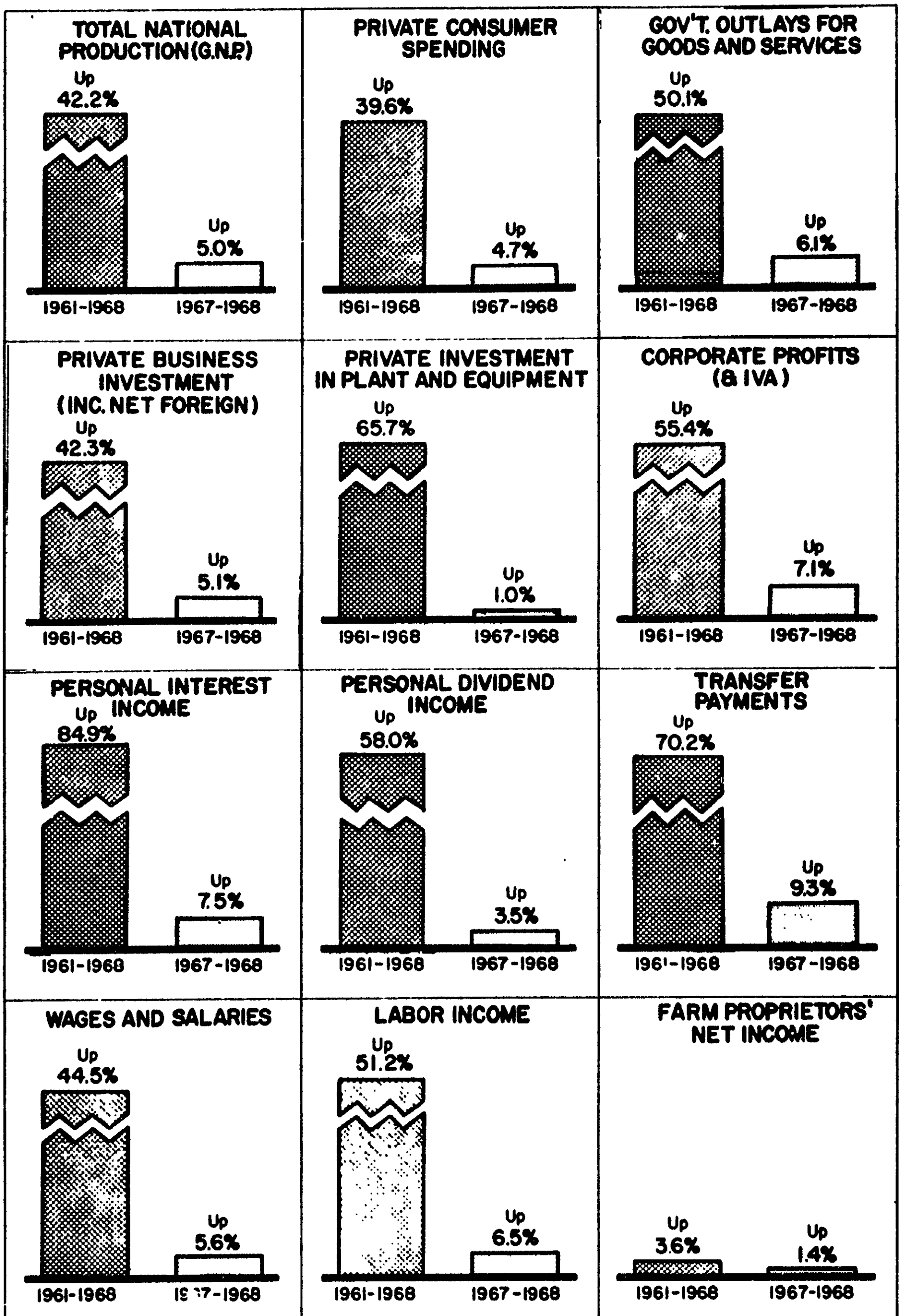
[2] Administration's Proposed Budget as of Jan. 29, 1968 Beginning with fiscal 1969, the Budget includes the immense trust funds, net lending, and other relatively minor new items. Note: Goals include Federal contributions of one billion in 1970, and more than two billion in 1977, to the OASDHI to help increase benefit payments to the aged.

Projections by Leon H. Keyserling.

Chart 5

COMPARATIVE GROWTH IN VARIOUS ASPECTS OF U.S. ECONOMY 1961-1968

(Constant Dollars)



Source: Dept. of Commerce, Office of Business Economics and CEP.

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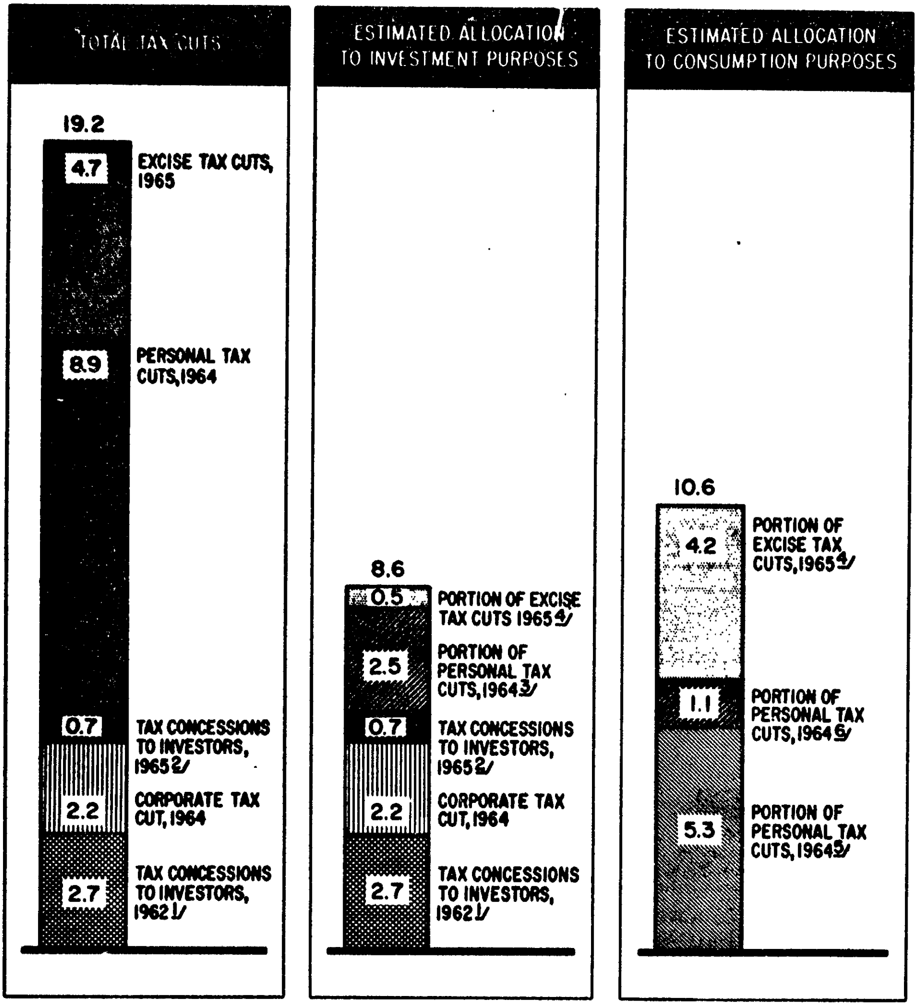
Chart 6

ALLOCATION OF TAX CUTS, 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



1/ Through Congressional & Executive Action

2/ Through Executive Action

3/ Estimated portion of personal tax cut, for those with incomes of $10,000 and over, which they would save for investment purposes.

4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.

5/ Personal tax cuts for those with incomes under $10,000.

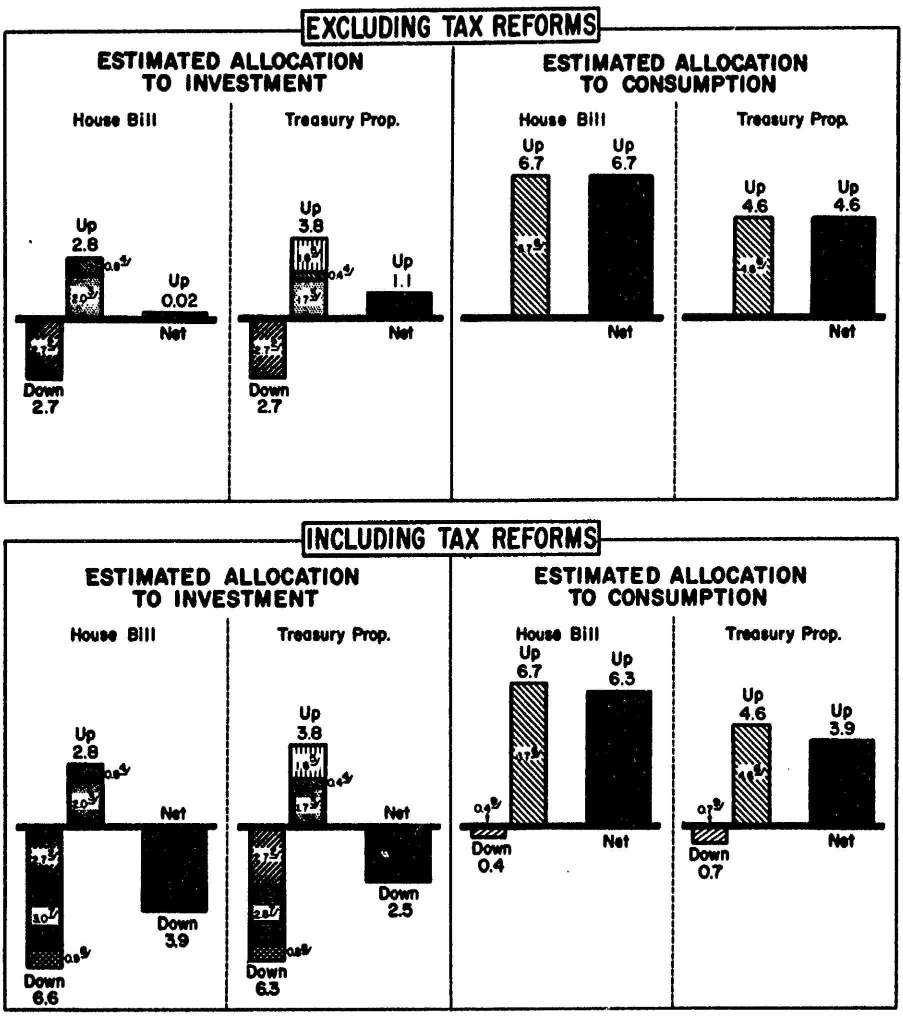
6/ Estimated portion of personal tax cuts for those with incomes of $10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions.) However, a large portion of this did not go to low income consumers.

Chart 7

ESTIMATED DIVISION OF PROPOSED TAX CUTS BETWEEN INVESTMENT AND CONSUMPTION

(Billions of Dollars 1/)



1/ Totals may not be exactly equal to sum of details shown, owing to rounding.

2/ Repeal of investment tax credit, effect on corporations.

3/ Estimated impact on personal saving of personal tax relief - and of individuals' share in repeal of investment tax credit.

4/ Investment incentives to corporations.

5/ Corporate tax relief.

6/ Estimated impact on personal consumption expenditure of personal tax relief and of individuals' share in repeal of investment tax credit.

7/ Effect of tax reforms on corporations.

8/ Estimated impact of tax reforms on personal saving.

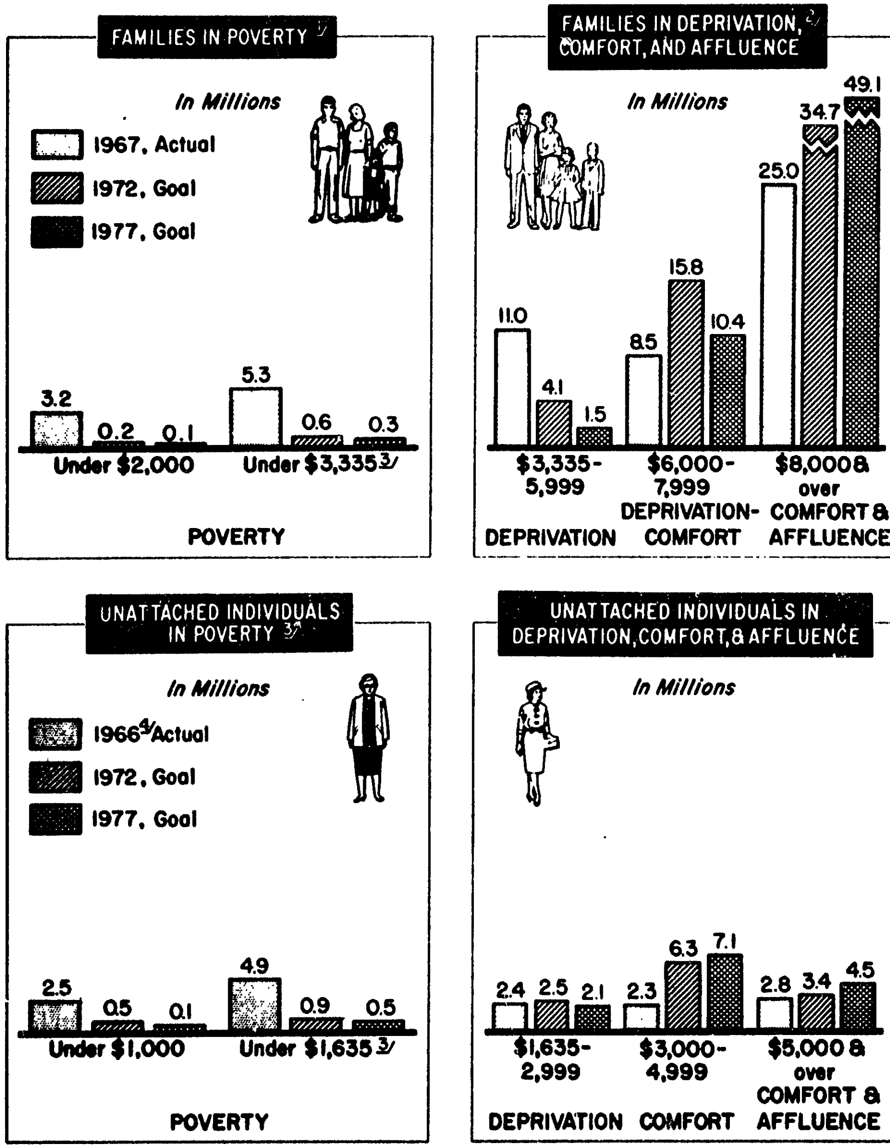
9/ Estimated impact of tax reforms on personal consumption expenditure.

Source: Basic data from Report of House Ways and Means Committee, and from statement of Treasury Assistant Secretary Cohen, September 4, 1969

Chart 8

NUMBER IN U.S. LIVING IN POVERTY, DEPRIVATION, COMFORT, AND AFFLUENCE, 1967, AND GOALS FOR 1972 AND 1977

Annual Money Incomes, Before Taxes, in 1967 Dollars



1/ Poverty-income ceilings vary by size of family. The figure of $3,335 applies to a family of four, according to the estimates of the Social Security Administration, Dept. of H.E.W. The average si[illegible] of families in poverty being four, 5.27 million families involve about 21.1 million people.

2/ The average size of families living in deprivation is about 3.0, coming to about 33 million people.

3/ The poverty-income ceiling of $1,635 accords with the estimates of the Social Security Administration, Dept. of H.E.W.

4/ 1967 not available. All projections, however, in 1967 dollars.

Basic Data: 1966, 1967: Social Security Administration, Dept. of H.E.W.; Bureau of the Census, Dept. of Commerce.

Chart 0

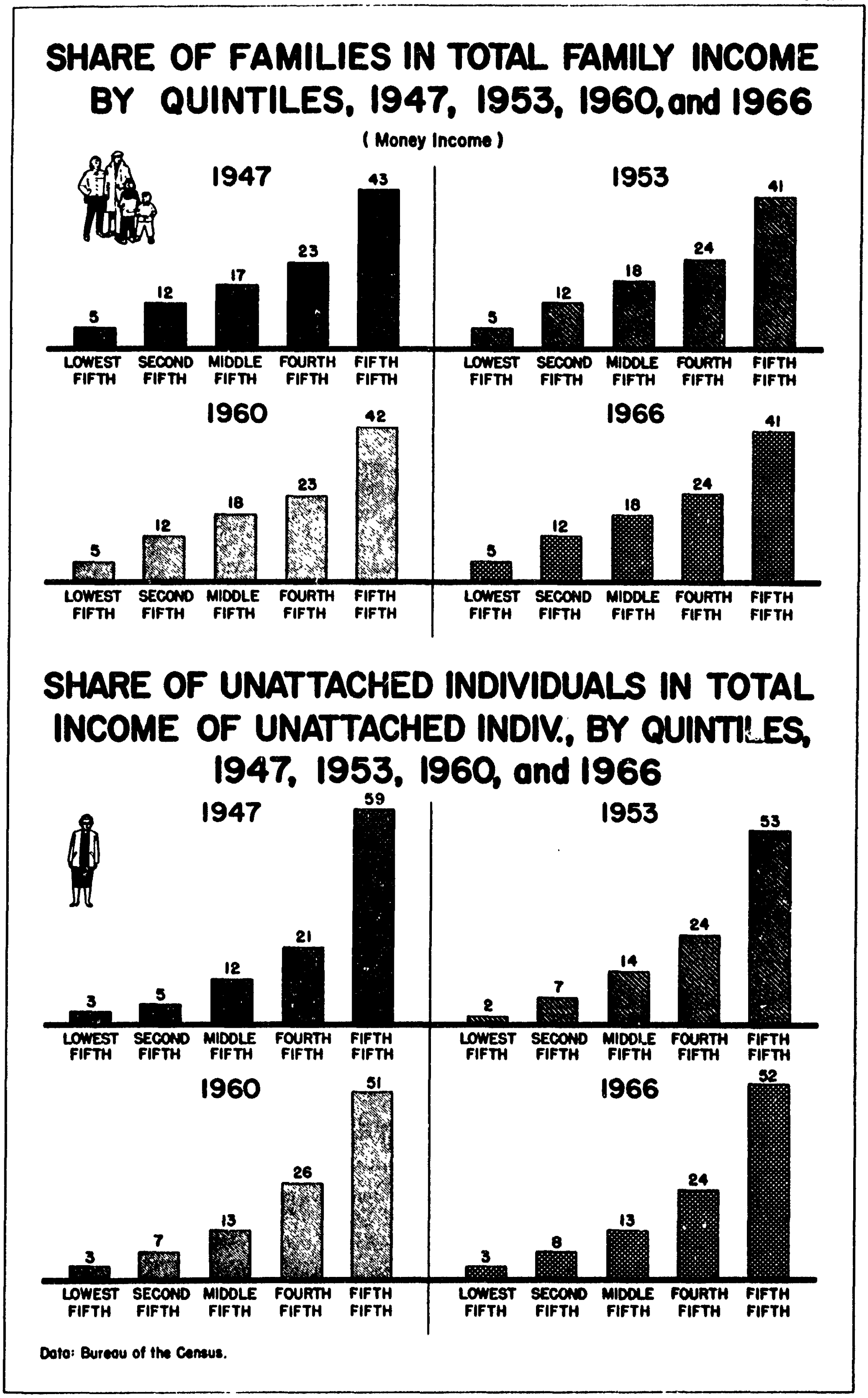
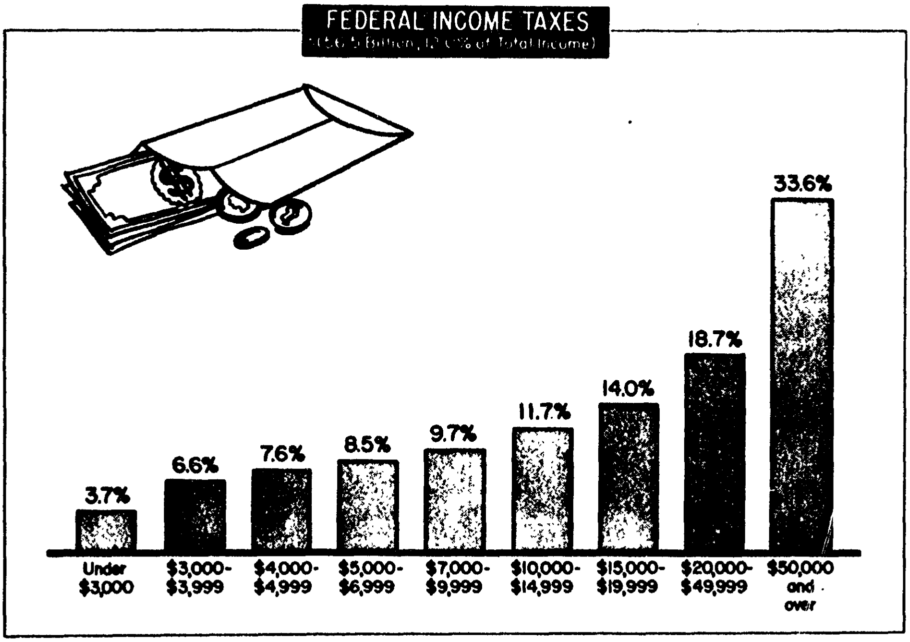
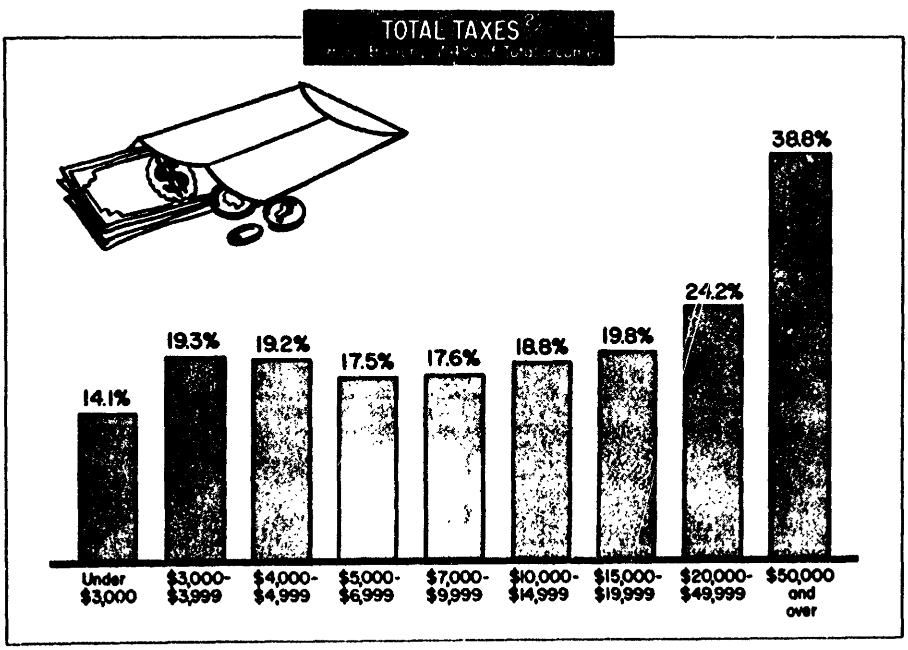

SHARE OF FAMILIES IN TOTAL FAMILY INCOME BY QUINTILES, 1947, 1953, 1960, and 1966
(Money Income)
1947
5
12
17
23
43
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
1953
5
12
18
24
41
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
1960
5
12
18
23
42
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
1966
5
12
18
24
41
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
SHARE OF UNATTACHED INDIVIDUALS IN TOTAL INCOME OF UNATTACHED INDIV., BY QUINTILES, 1947, 1953, 1960, and 1966
1947
3
5
12
21
59
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
1953
2
7
14
24
53
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
1960
3
7
13
26
51
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
1966
3
8
13
24
52
LOWEST FIFTH
SECOND FIFTH
MIDDLE FIFTH
FOURTH FIFTH
FIFTH FIFTH
Data: Bureau of the Census.

Chart 10

TAXES PAID AS % OF INCOME, U.S. 1966[1]





1/ Income relates to "Total Gross Adjusted Income" of all persons in the income classes shown.

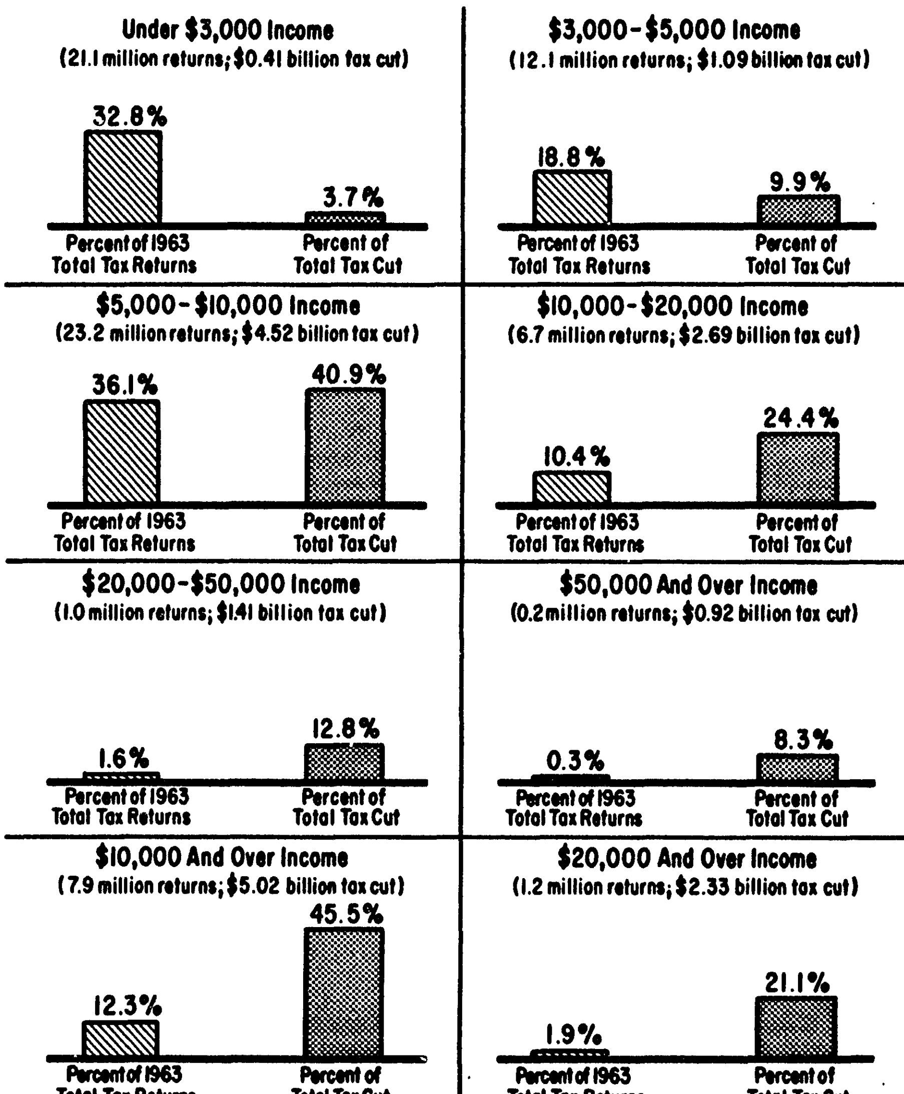
2/ Includes Federal income taxes; social security taxes; State and local income, sales and gasoline taxes; and personal property and real estate taxes.

Basic Data: Internal Revenue Service and Brookings Institution

Chart 11

ADMINISTRATION PLAN, PERSONAL TAX CUTS EXCLUDING PROPOSED TAX REFORMS

Distribution Of Total Tax Returns 1/ And Of Total Tax Cuts 2/ Among Various Income Groups 3/



Estimated 1963 Total Tax Returns-64.3 Million

Estimated 1963 Tax-$47.4 Billion; Proposed Tax-$36.4 Billion; Proposed Tax Cut-$11 Billion

1/ All 1963 returns (taxable and nontaxable). CEP estimates based on Treasury Dept. data.

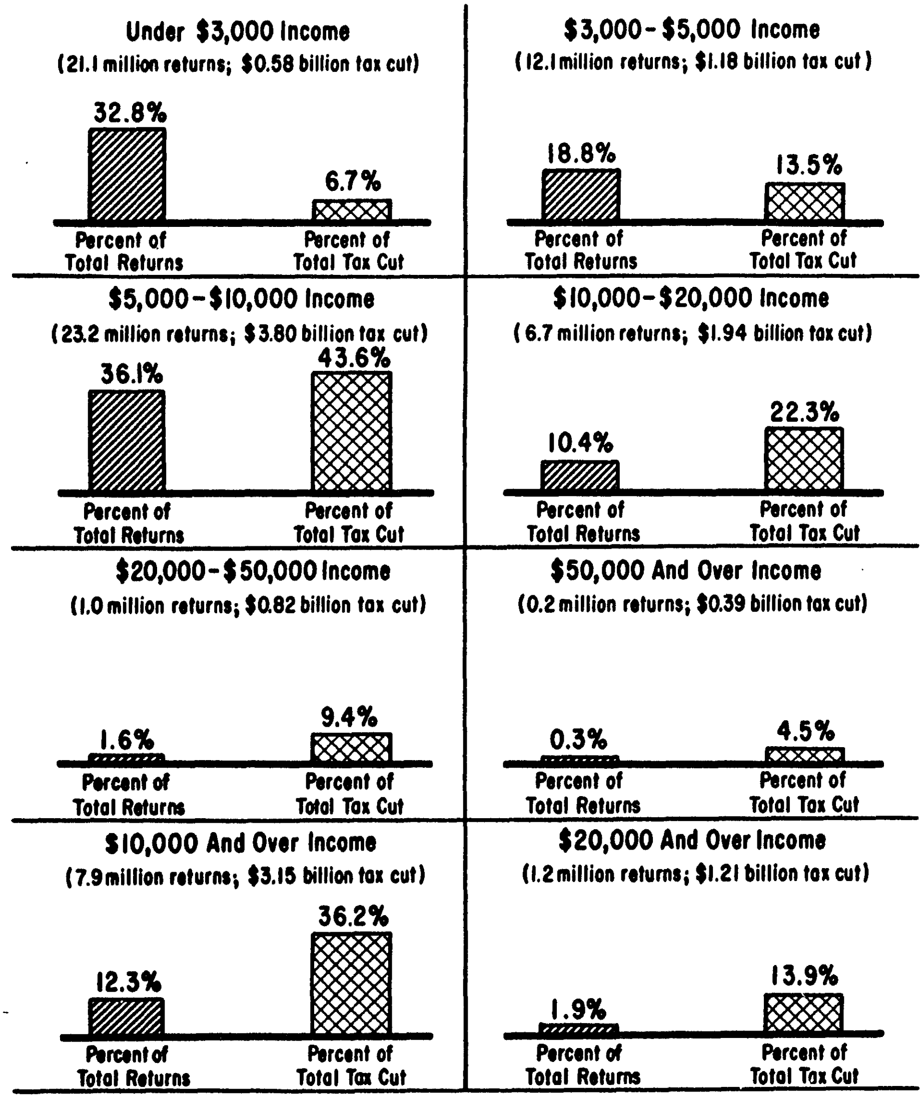
2/ Tax cuts as of 1965 (when plan would become fully effective) as proposed in President's 1963 Tax Message and Treasury Dept. data as of Feb. 6, '63, applied to 1963 income structure.

3/ Adjusted gross income levels as of 1963, estimated by CEP on basis of Treasury Dept. data.

Chart 12

ADMINISTRATION PLAN, PERSONAL TAX CUTS INCLUDING PROPOSED TAX REFORMS

Distribution Of Total Tax Returns[1] And Of Total Tax Cuts[2] Among Various Income Groups[3]



Estimated 1963 Total Tax Returns-64.3 Million

Estimated 1963 Tax-$47.4 Billion; Proposed Tax-$38.7 Billion; Proposed Tax Cut-$8.7 Billion.

1/ All 1963 returns (taxable and nontaxable). CEP estimates based on Treasury Dept. data.

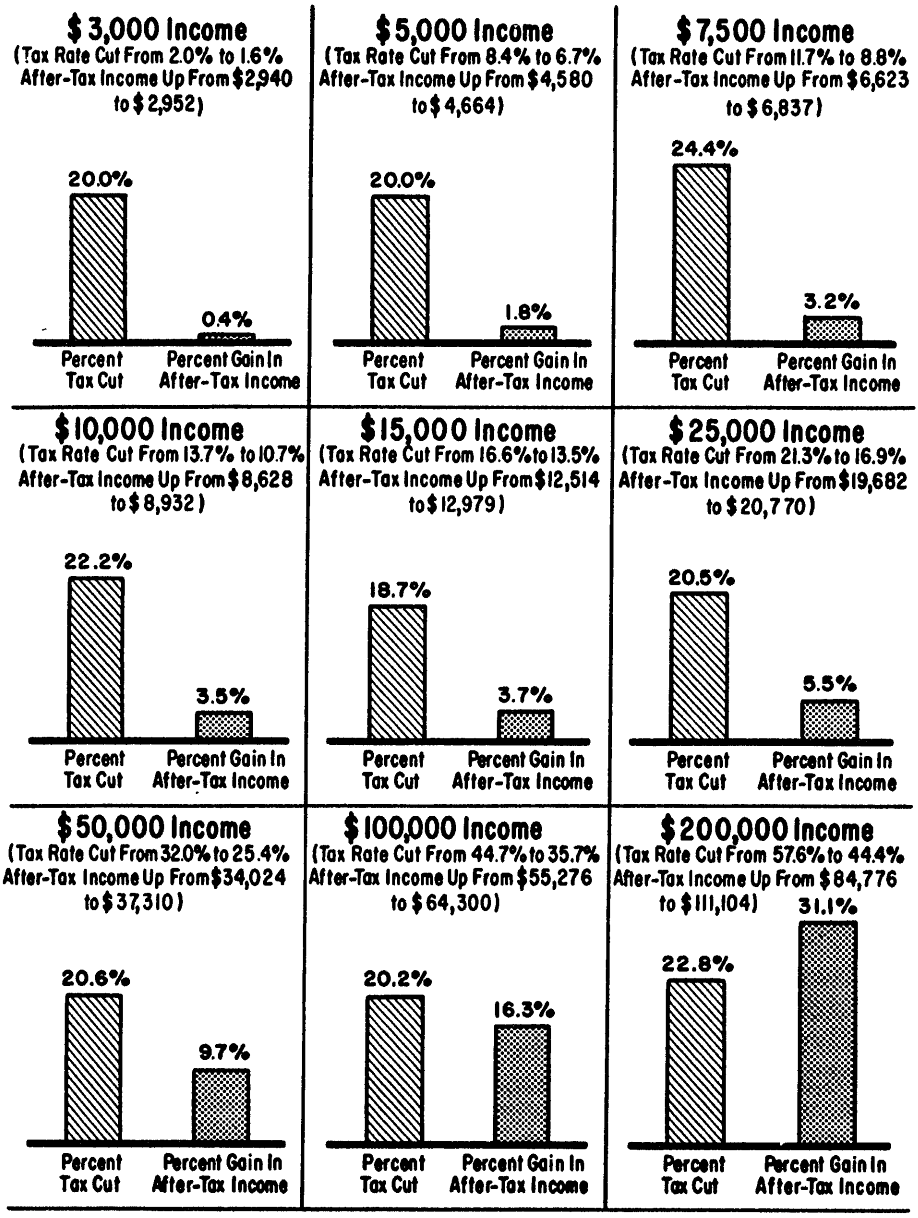
2/ Tax cuts as of 1965 (when plan would become fully effective) as proposed in President's 1963 Tax Message and Treasury Dept. data as of Feb. 6, 1963, applied to 1963 income structure. Effect of capital gains revision excluded.

3/ Adjusted gross income levels as of 1963, estimated by CEP on basis of Treasury Dept. data.

Chart 13

ADMINISTRATION PLAN, PERSONAL TAX CUTS EXCLUDING PROPOSED TAX REFORMS

Percent Tax Cut And Percent Gain In After-Tax Income
Married Couple With Two Children At Various Income Levels[1]



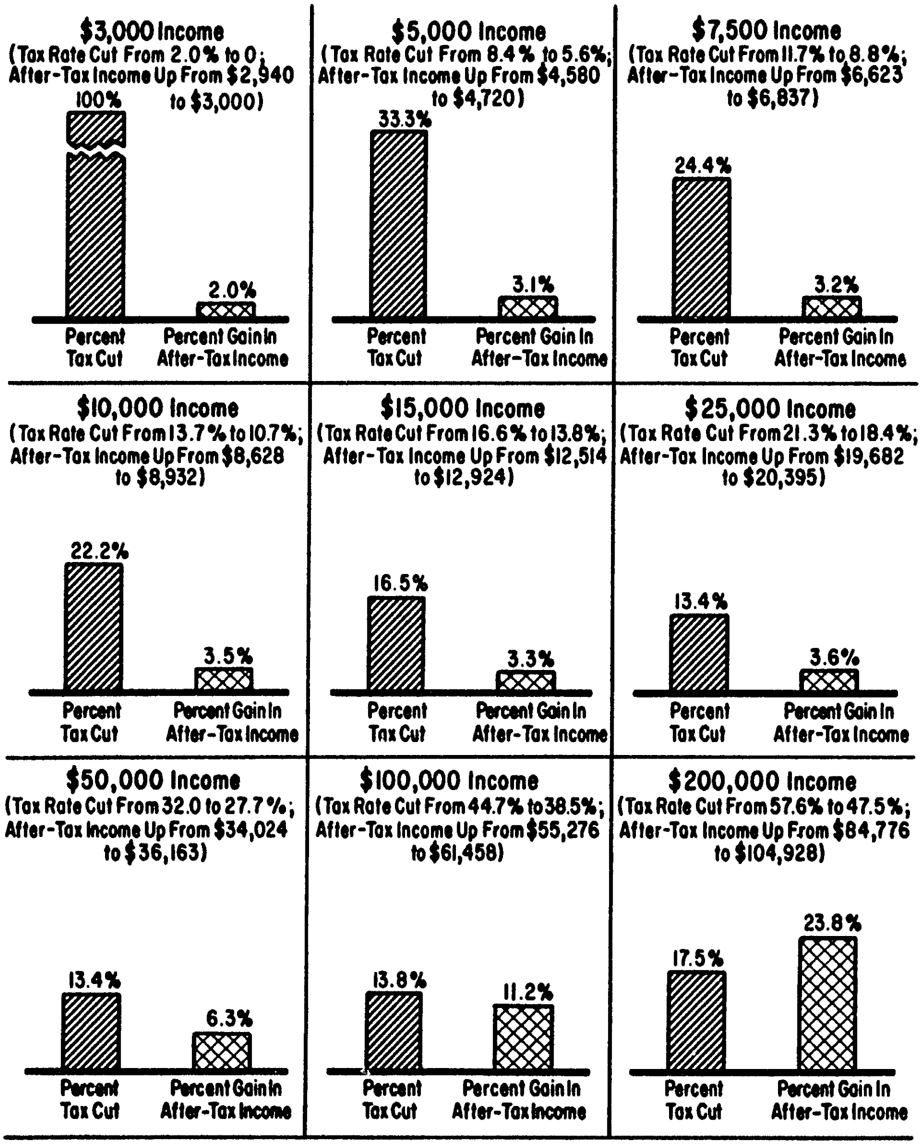
[1] Adjusted gross income levels.

Note: Present and proposed tax based on assumption of 10 percent deductions for taxes, interest, contributions, medical care, etc. Proposed tax based on the President's proposal, and Treasury Dept. data, as of Feb. 6, '63.

Chart 15

ADMINISTRATION PLAN, PERSONAL TAX CUTS INCLUDING PROPOSED TAX REFORMS

Percent Tax Cut And Percent Gain In After-Tax Income Married Couple With Two Children At Various Income Levels[1]

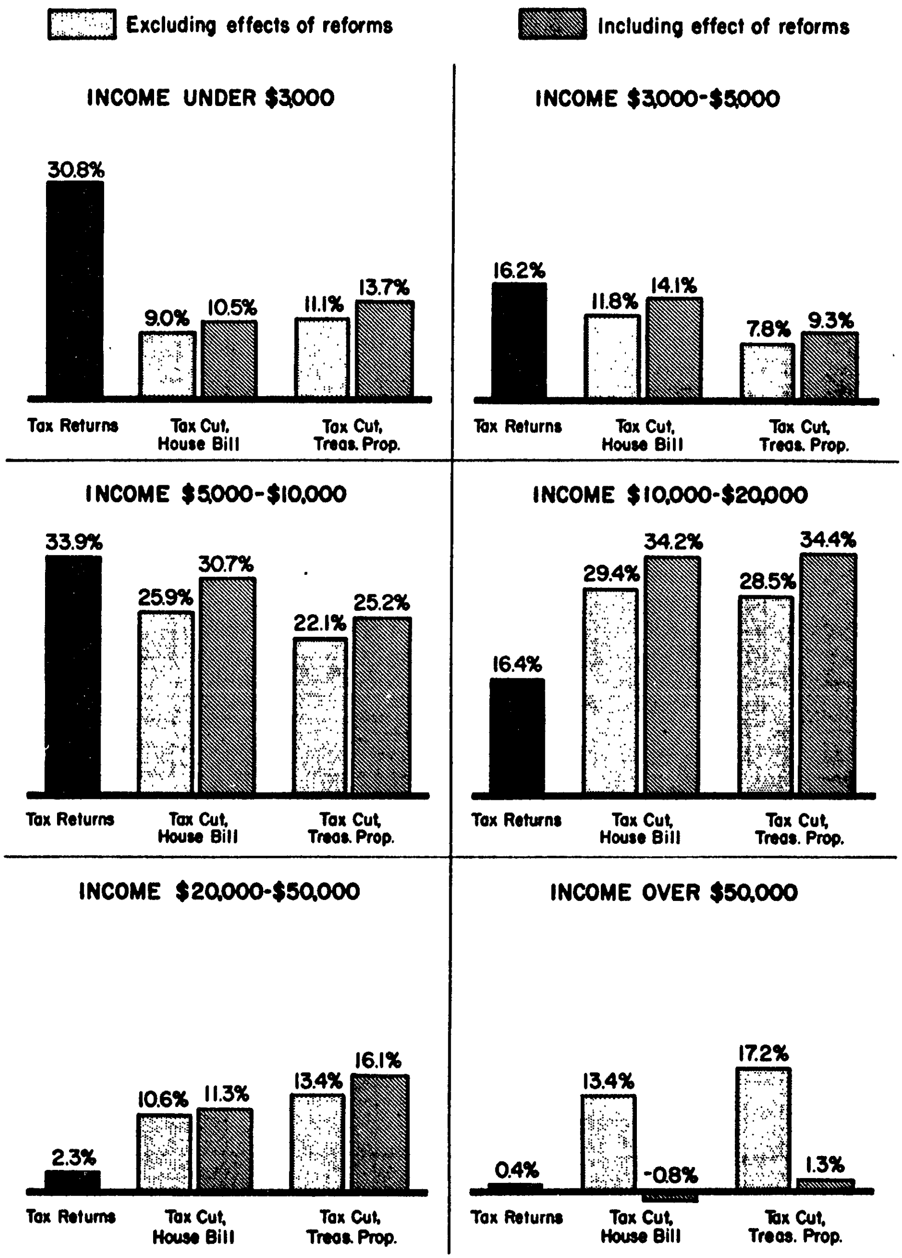


[1] Adjusted gross income levels.

Note: Present tax based on assumption of 10 percent deduction for taxes, interest, contributions, medical care, etc. Proposed tax based on the President's proposal, and Treasury Dept. data, as of Feb.6,'63.

Chart 15

PERCENTAGE DISTRIBUTION OF TAX RETURNS[1] AND OF PROPOSED TAX CUTS[2] AMONG VARIOUS INCOME GROUPS[3]



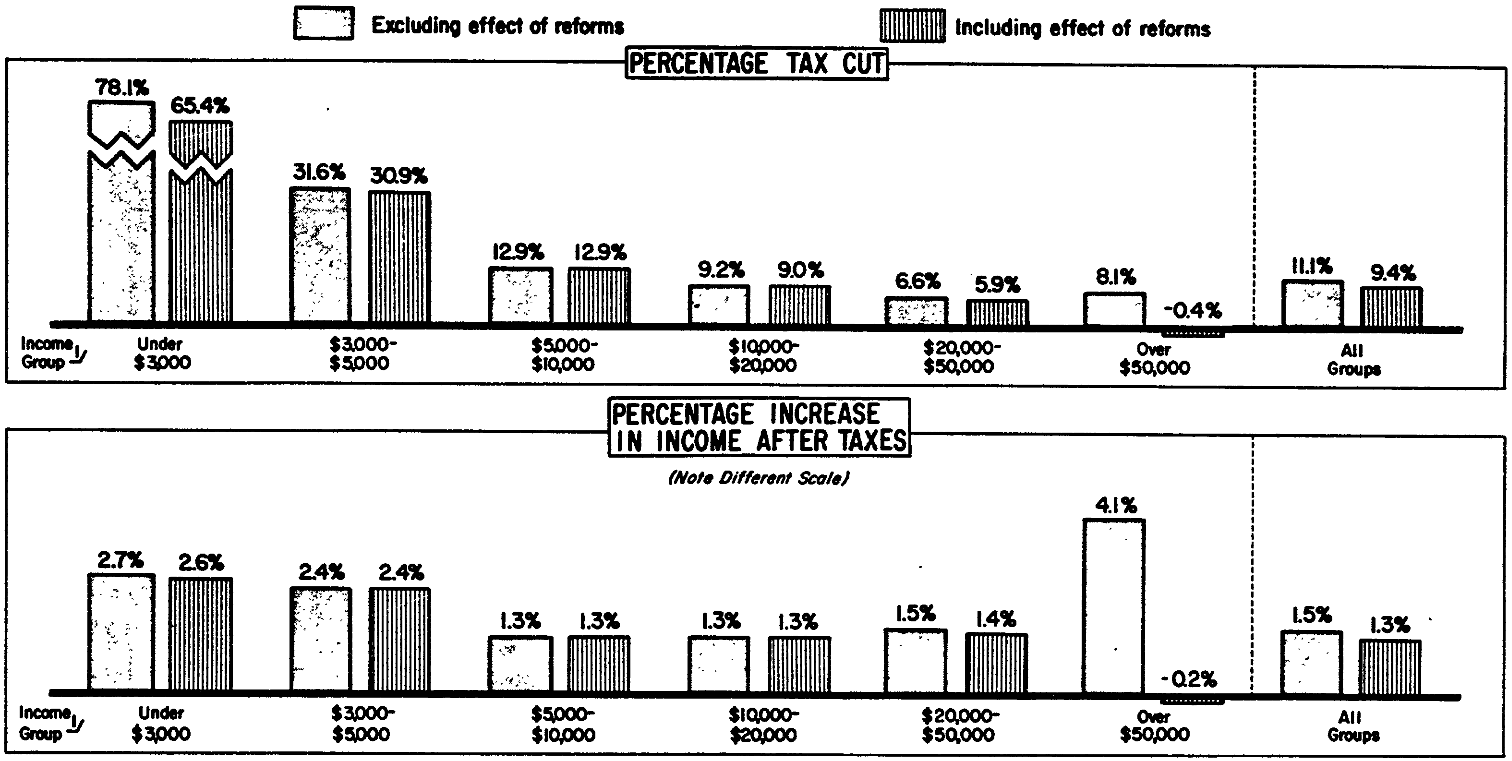
1/ All 1966 individual income tax returns (latest year available): Treasury Dept., Internal Revenue Service, Statistics of Income.

2/ H.R. 13270 and Treasury Proposal of September 4, 1969. Basic data from statement of Treasury Secretary Kennedy and Assistant Secretary Cohen.

3/ Adjusted gross income classes.

Chart 16

HOUSE BILL, PERCENTAGE TAX CUT AND PERCENTAGE INCREASE IN INCOME AFTER TAX, VARIOUS INCOME GROUPS

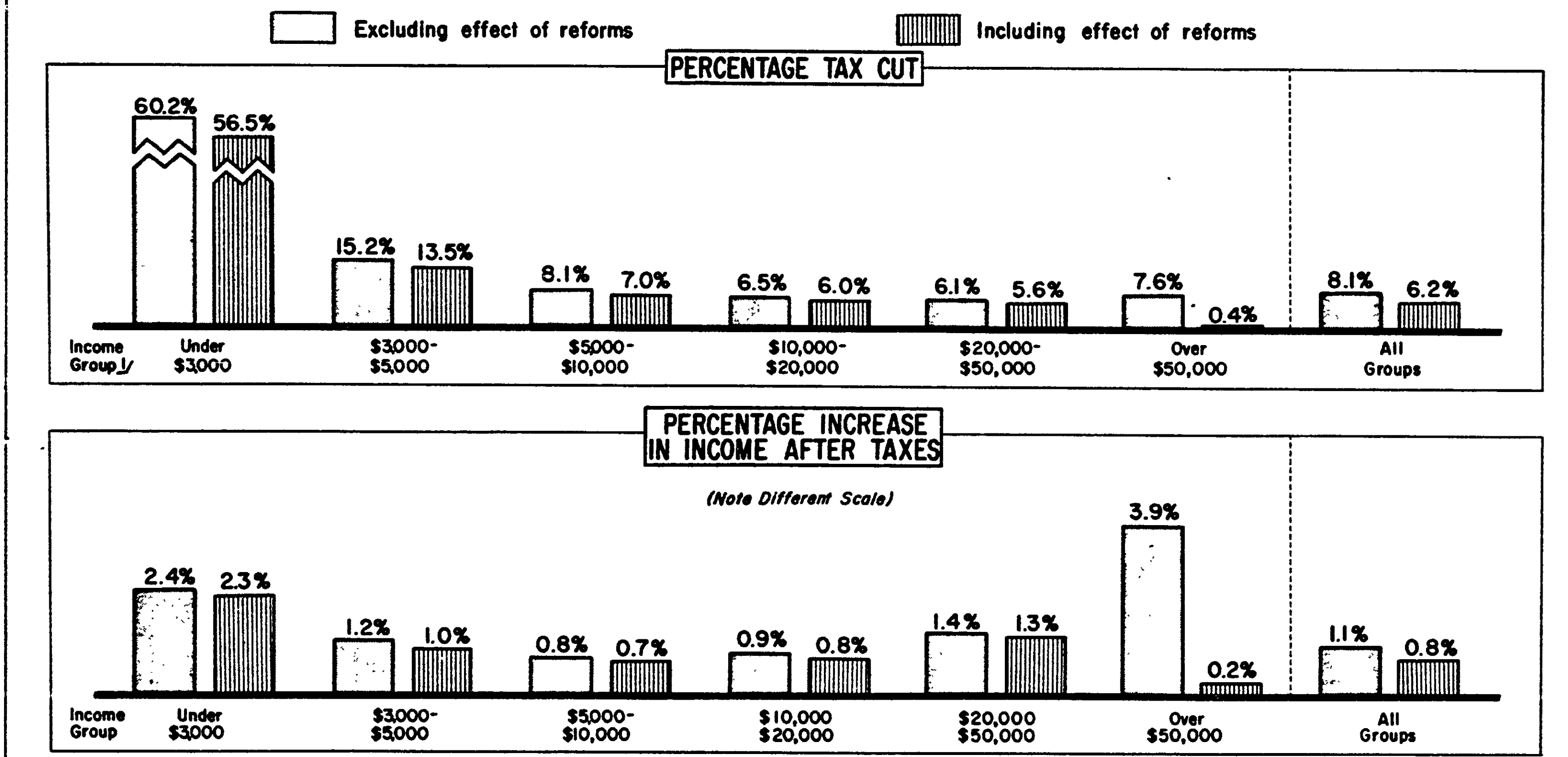


1/ Adjusted gross income class.

Source: Basic data from Report of House Ways and Means Committee, accompanying H.R. 13270

Chart 17

TREASURY PROPOSAL, PERCENTAGE TAX CUT AND PERCENTAGE INCREASE IN INCOME AFTER TAX, VARIOUS INCOME GROUPS

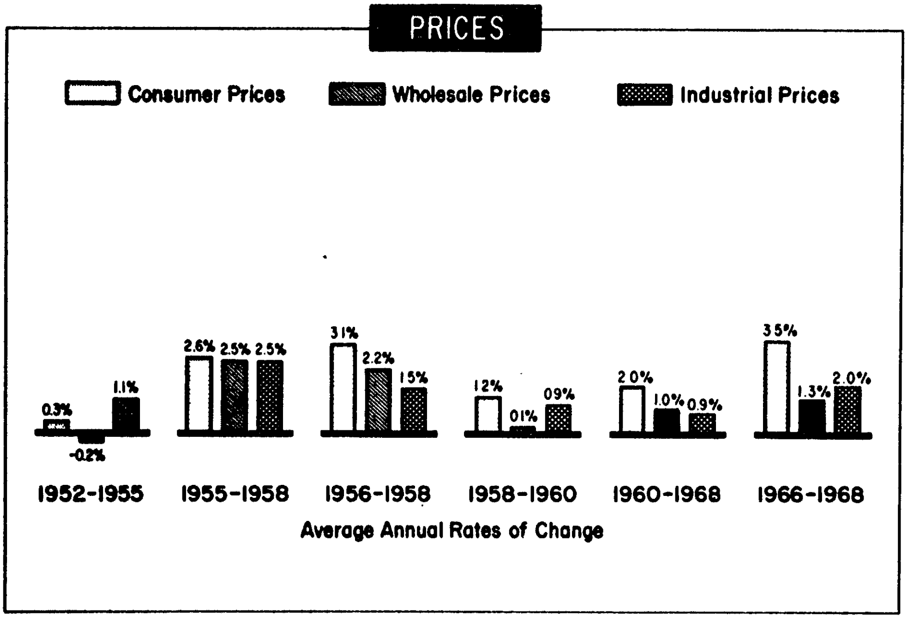


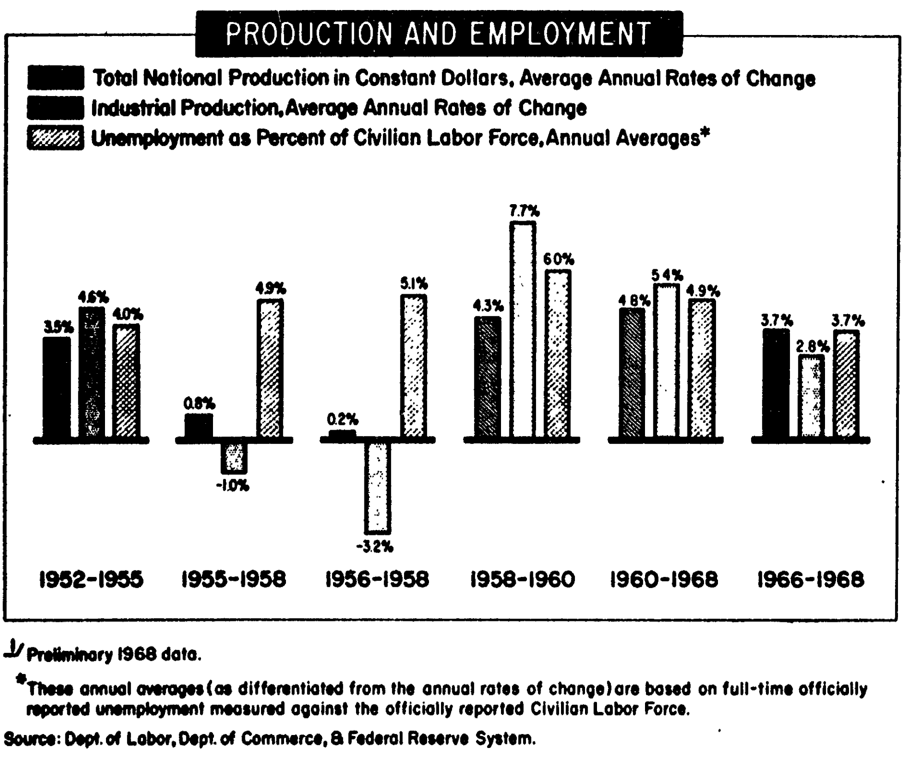
1/ Adjusted gross income class.

Source: basic data from Statement of Treasury Assistant Secretary Cohen, September 4, 1969

Chart 18

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952-1968[1]





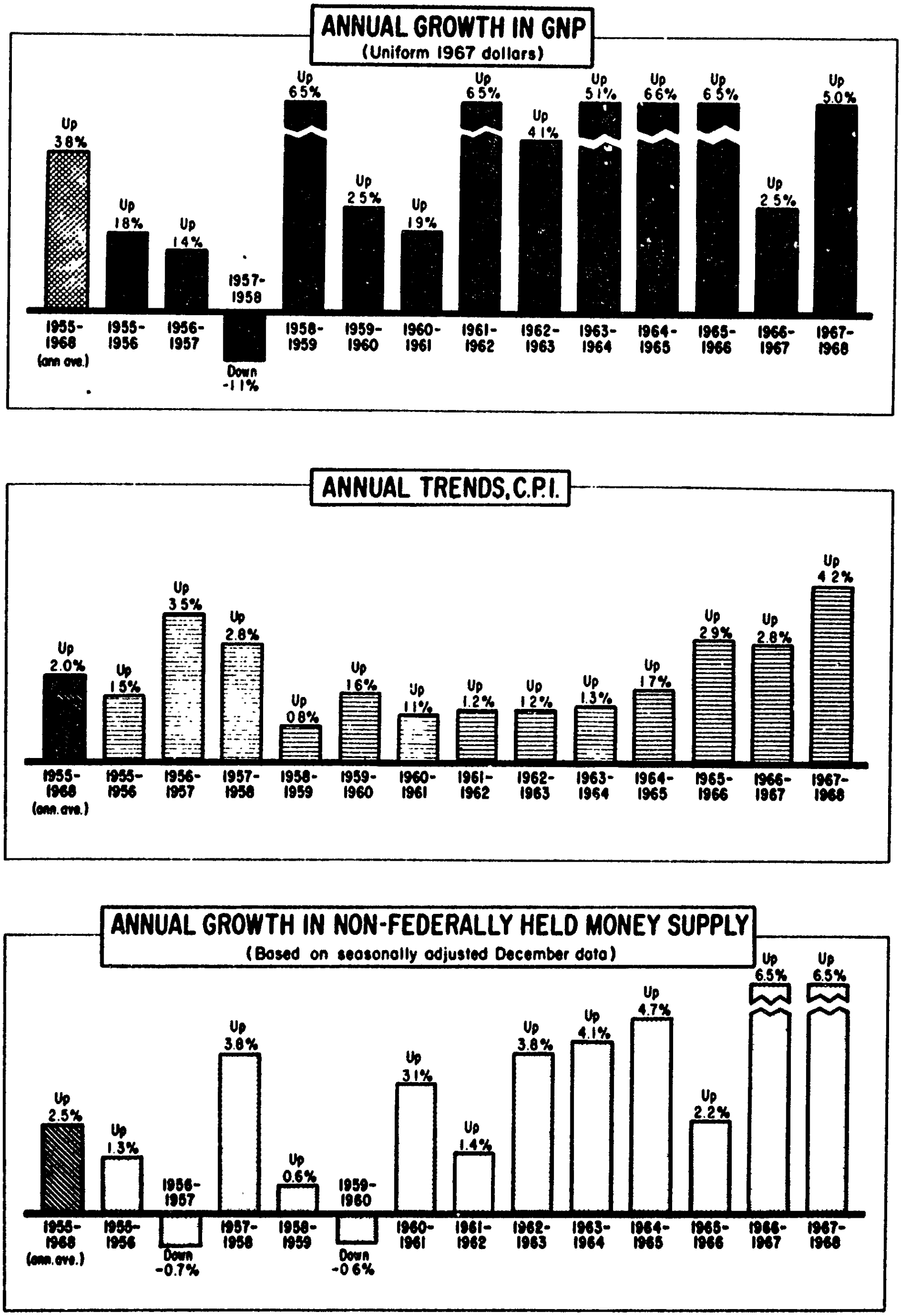
[1] Preliminary 1968 data.

*These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept. of Labor, Dept. of Commerce, & Federal Reserve System.

Chart 19

COMPARATIVE TRENDS IN GNP, PRICES, AND NON-FEDERALLY HELD MONEY SUPPLY, 1955-1968[1]



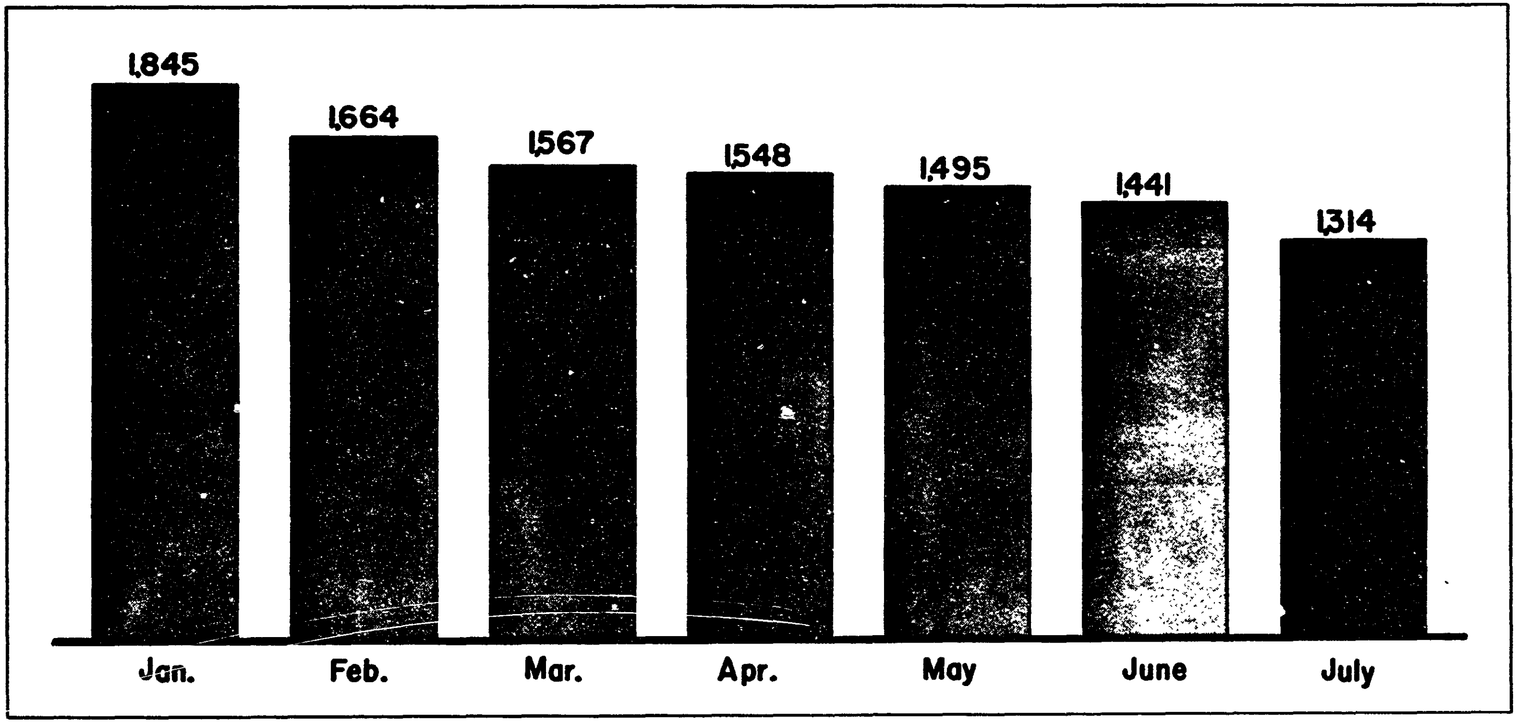
[1] All 1968 data preliminary.

Data: Economic Report of the President

Chart 20

PRIVATE NON-FARM HOUSING STARTS, 1969

(Thousands of units, seasonally adjusted at annual rates)

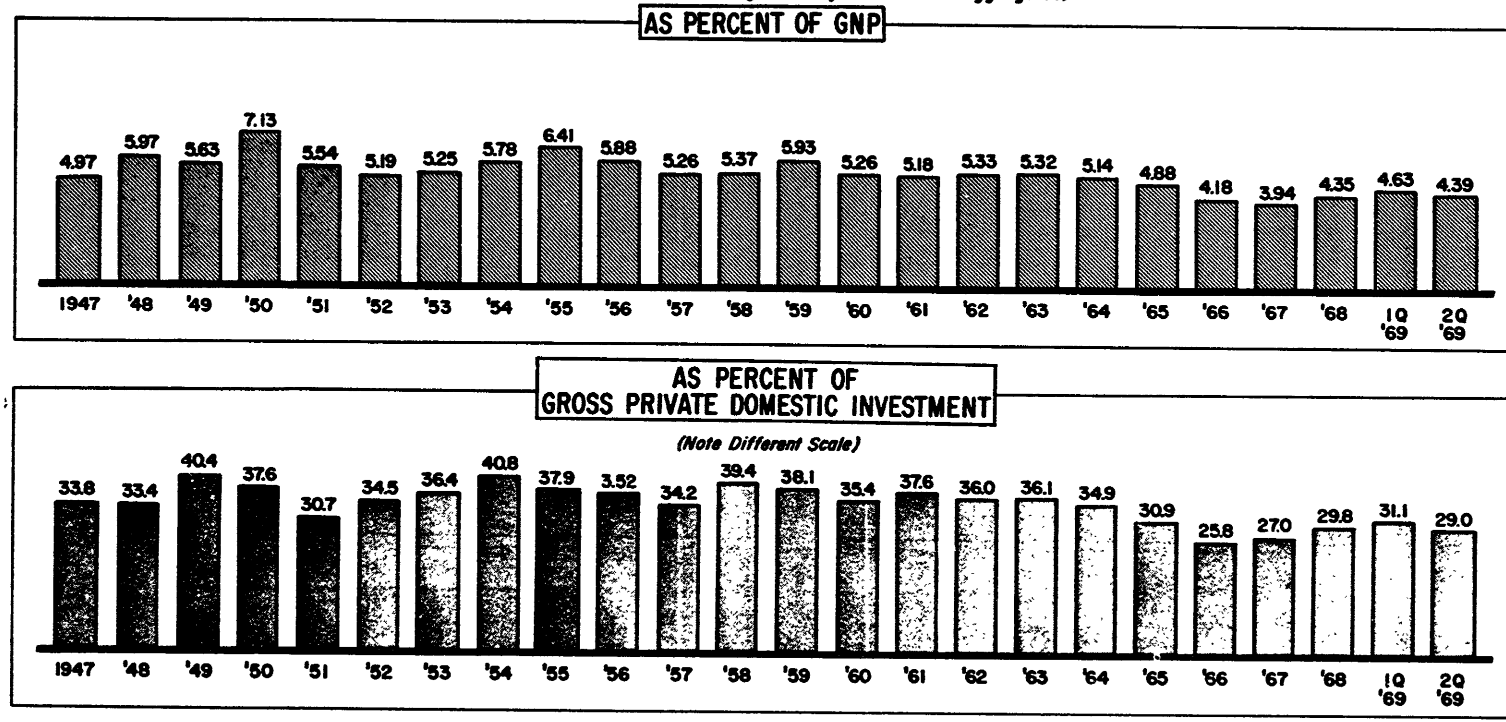


Source: Council of Economic Advisers, Economic Indicators

Chart 21

ROLE OF HOUSING AND COMMERCIAL CONSTRUCTION IN THE NATIONAL ECONOMY, 1947-1969

(New Construction as Percentage of Major Economic Aggregates)



Source: Dept. of Commerce, Office of Business Economics, Survey of Current Business

Chart 22

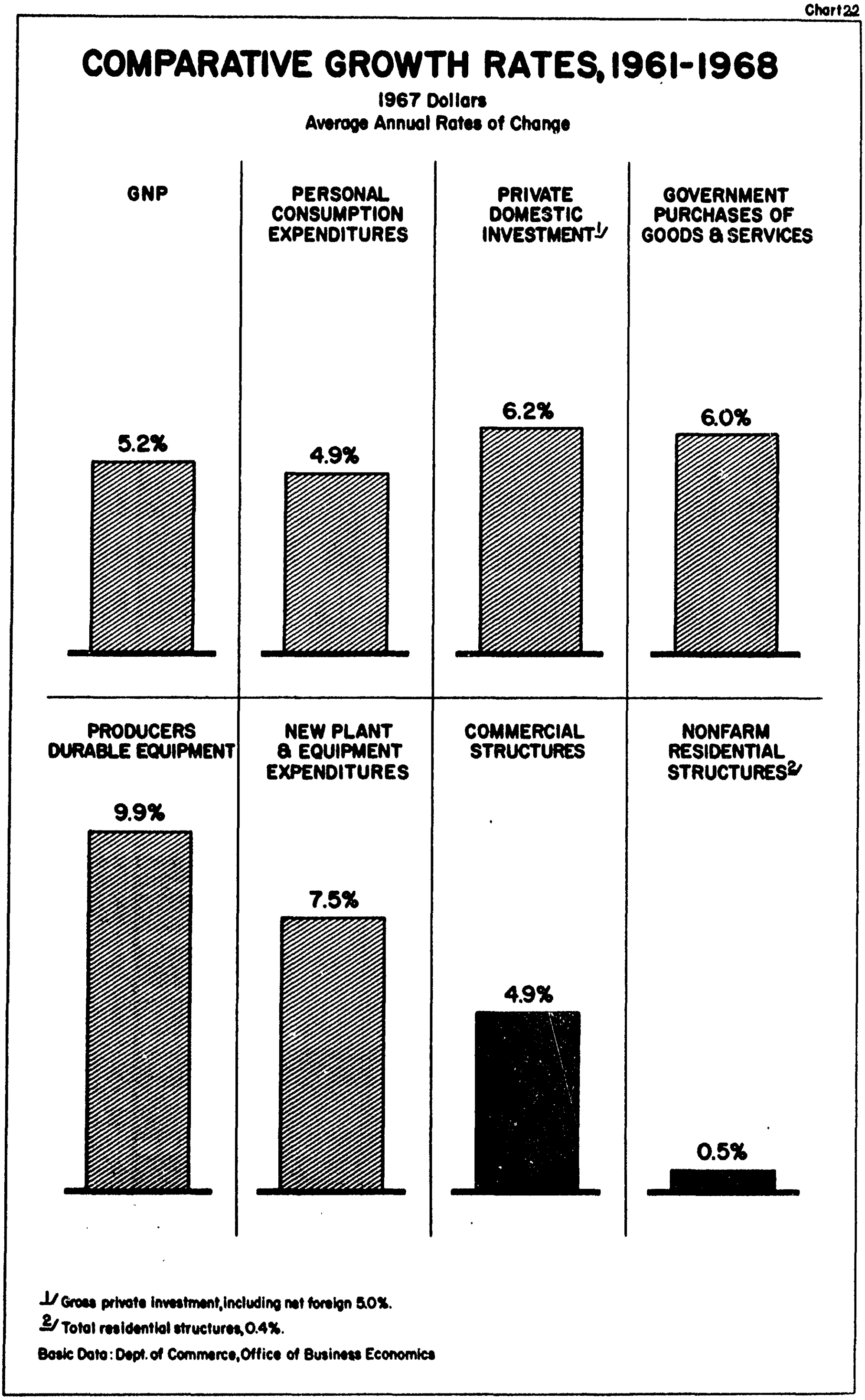

COMPARATIVE GROWTH RATES, 1961-1968
1967 Dollars
Average Annual Rates of Change
GNP
5.2%
PERSONAL CONSUMPTION EXPENDITURES
4.9%
PRIVATE DOMESTIC INVESTMENT 1/
6.2%
GOVERNMENT PURCHASES OF GOODS & SERVICES
6.0%
PRODUCERS DURABLE EQUIPMENT
9.9%
NEW PLANT & EQUIPMENT EXPENDITURES
7.5%
COMMERCIAL STRUCTURES
4.9%
NONFARM RESIDENTIAL STRUCTURES 2/
0.5%
1/ Gross private investment, including net foreign 5.0%.
2/ Total residential structures, 0.4%.
Basic Data: Dept. of Commerce, Office of Business Economics

Chart 23

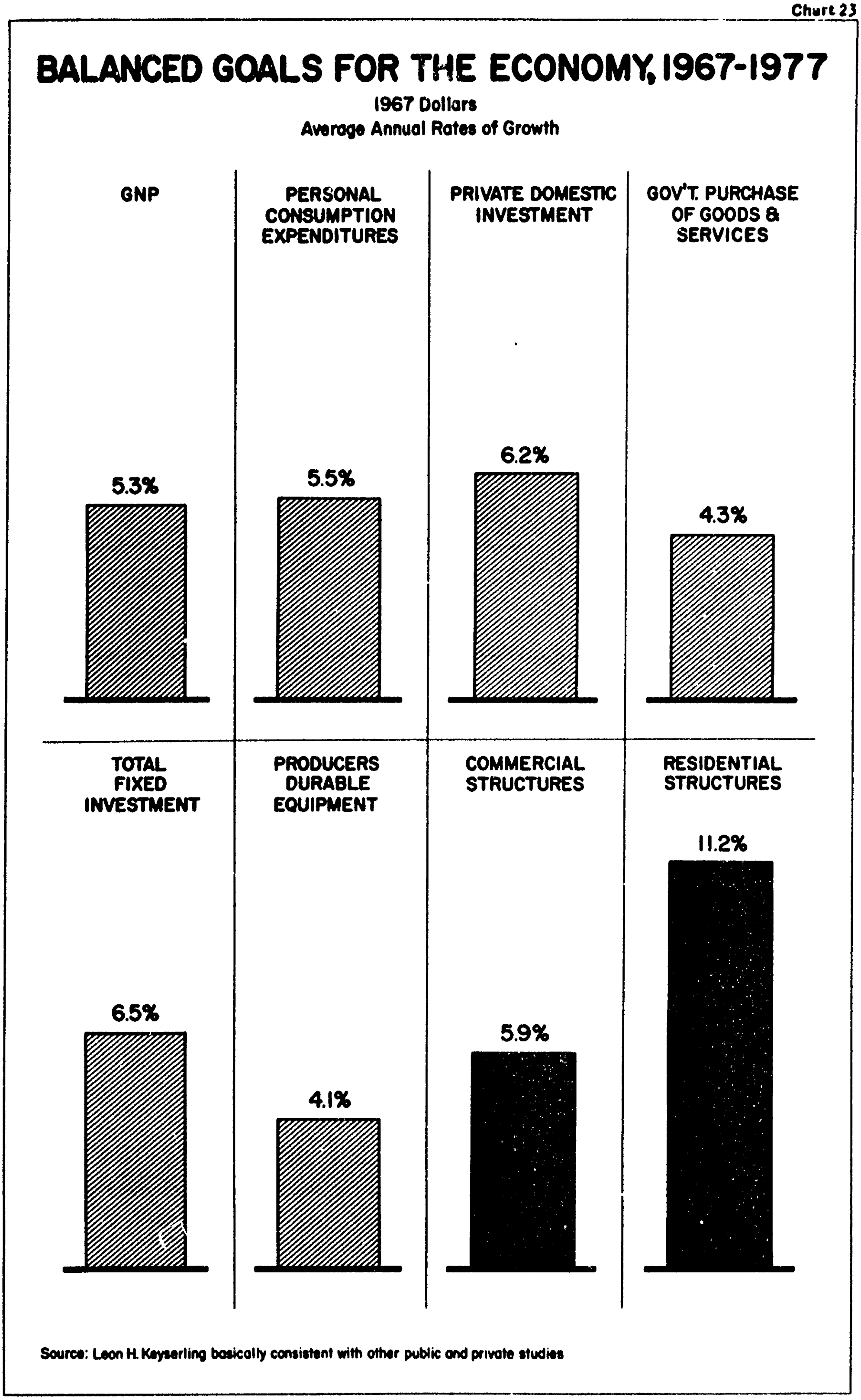
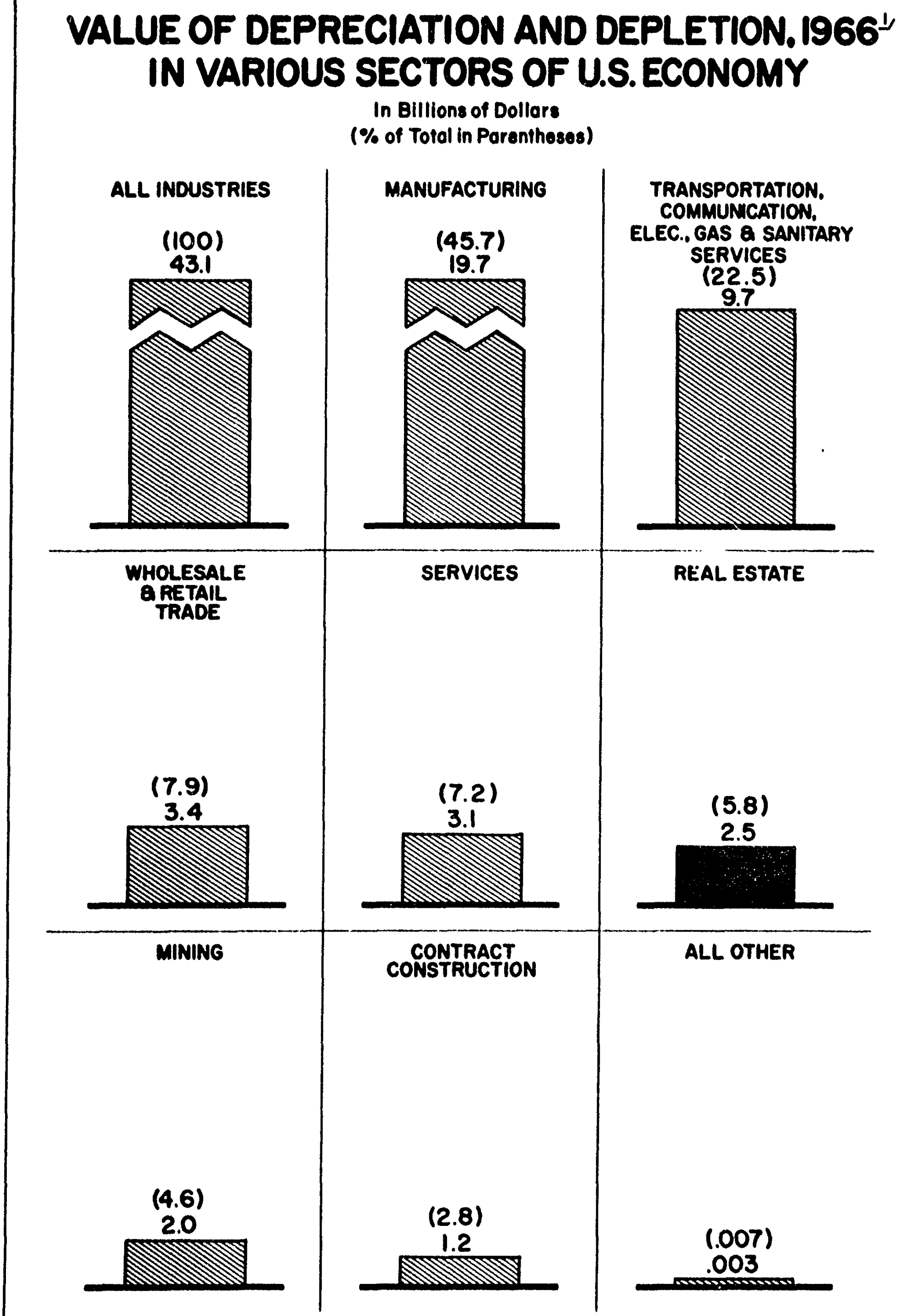

BALANCED GOALS FOR THE ECONOMY, 1967-1977
1967 Dollars
Average Annual Rates of Growth
GNP
5.3%
PERSONAL CONSUMPTION EXPENDITURES
5.5%
PRIVATE DOMESTIC INVESTMENT
6.2%
GOV'T. PURCHASE OF GOODS & SERVICES
4.3%
TOTAL FIXED INVESTMENT
6.5%
PRODUCERS DURABLE EQUIPMENT
4.1%
COMMERCIAL STRUCTURES
5.9%
RESIDENTIAL STRUCTURES
11.2%
Source: Leon H. Keyserling basically consistent with other public and private studies

Chart 24



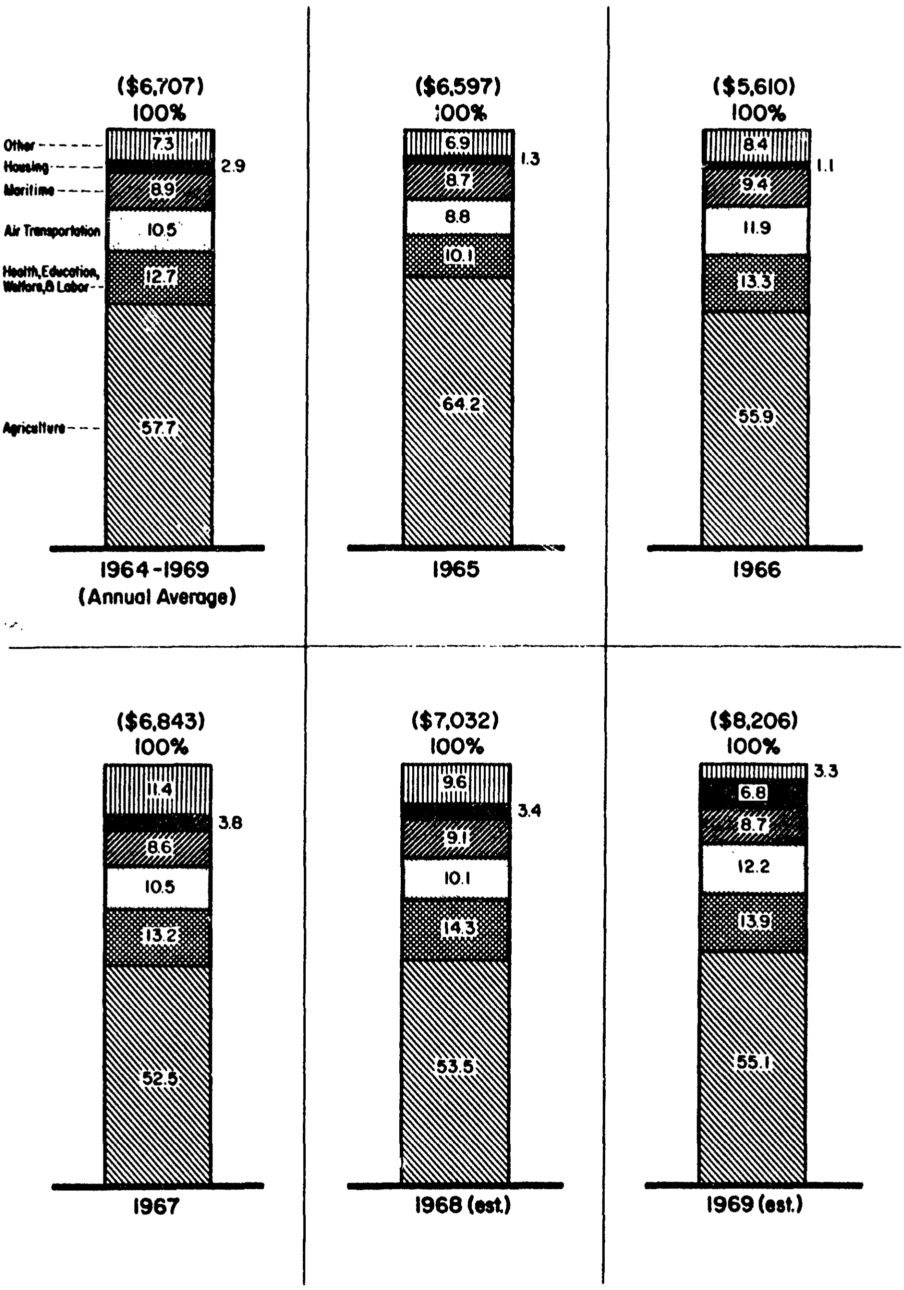
[1/] As expressed in corporate income tax returns.

Source: Treasury Dept.

Chart 25

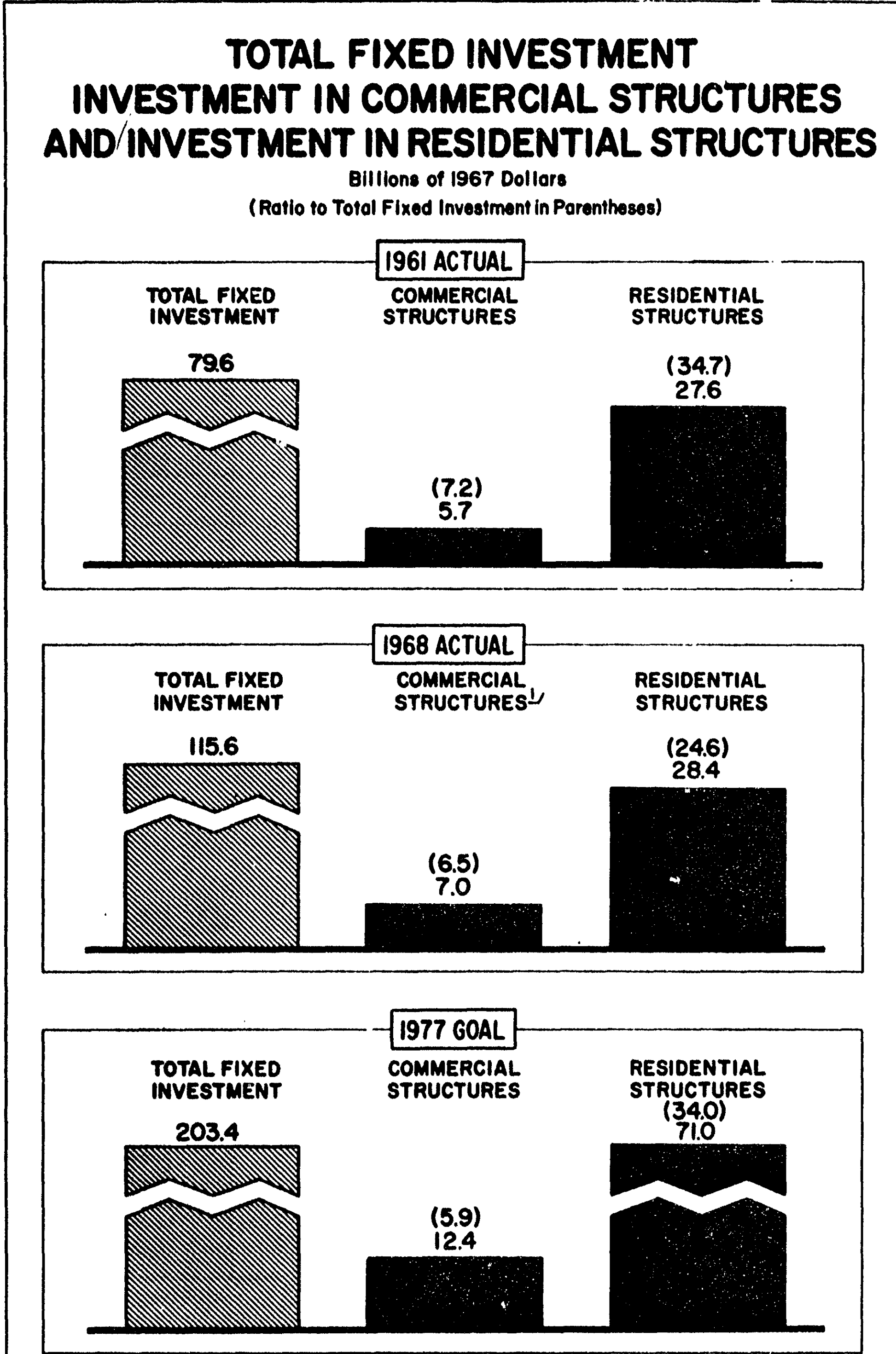
% DISTRIBUTION OF NET FEDERAL EXPENDITURES FOR SUBSIDY PROGRAMS, FY 1964-1969

(Millions of Current Dollars in Parentheses)



Source: Dept. of Commerce

Chart 26

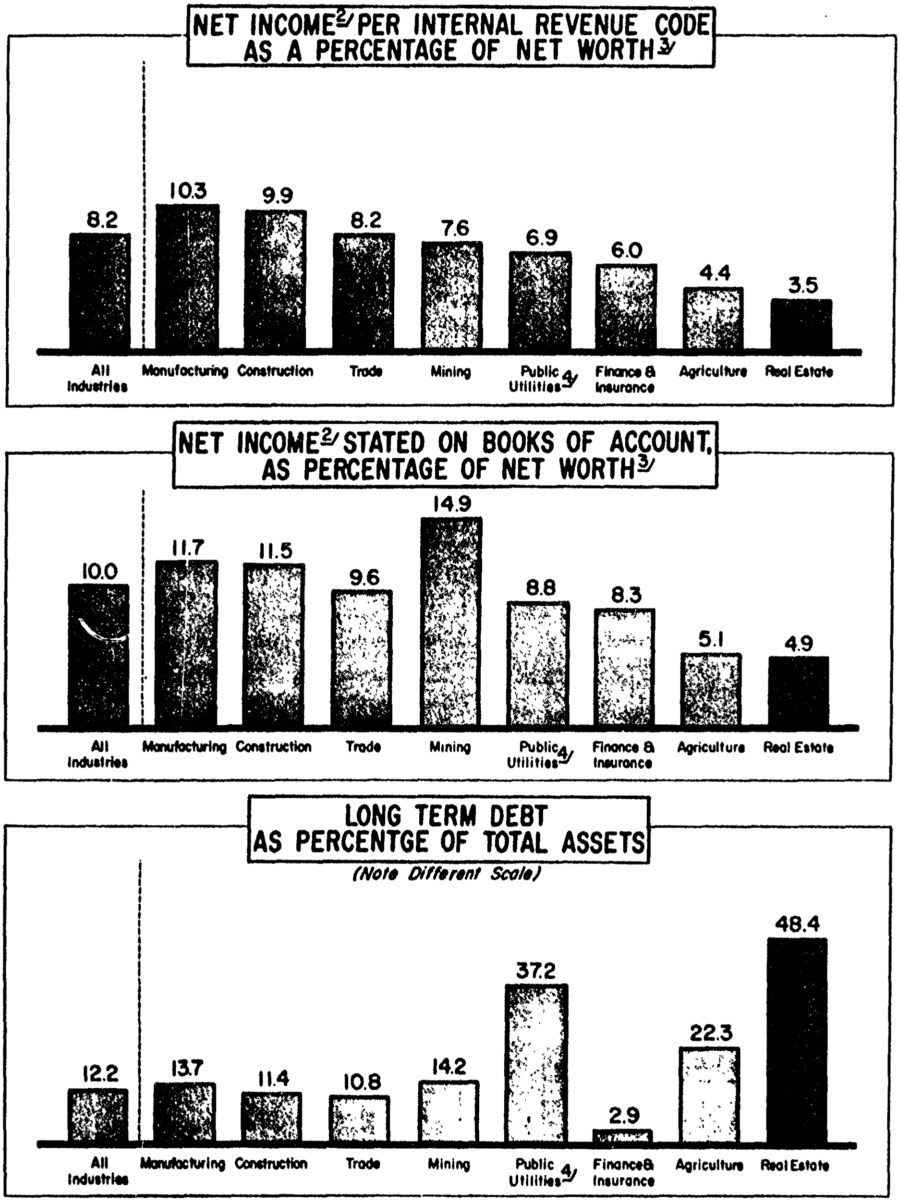


1/ 1967; 1968 not available.

Basic Data: Dept. of Commerce, Office of Business Economics

Chart 27

RATES OF RETURN & OTHER FINANCIAL RATIOS ALL CORPORATIONS IN VARIOUS INDUSTRIES, 1965 1/



1/ Latest year available.

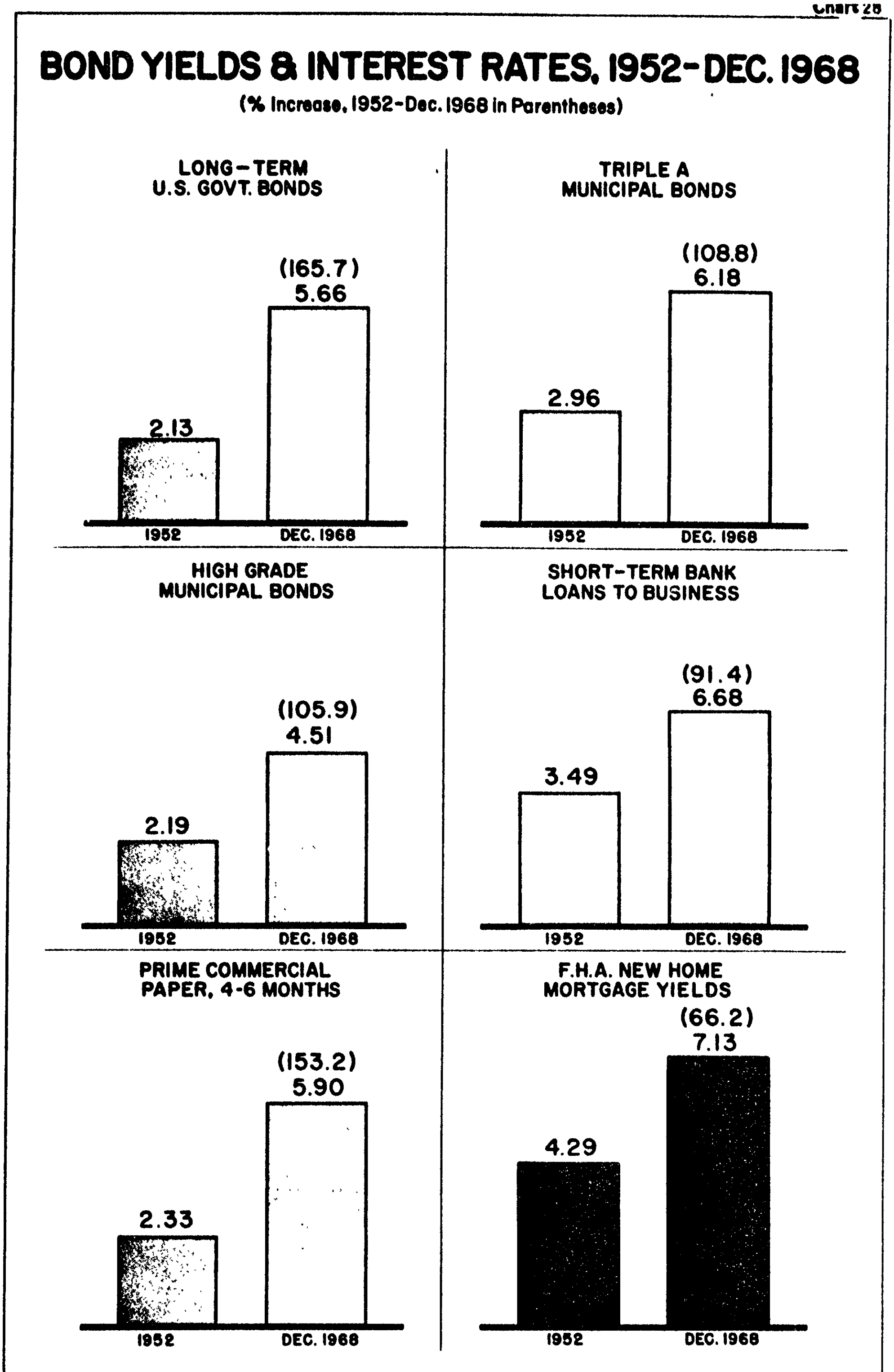
2/ Net income after Federal income tax.

3/ Stockholder equity.

4/ Including transportation.

Source: Treasury Dept., Internal Revenue Service, Statistics of Income, 1965 Corporation Income Tax Returns

Chart 28



Source: Treasury Dept.; Federal Reserve; F.H.A.

APPENDIX 1

MEMBERSHIP OF REALTY COMMITTEE ON TAXATION

Albert B. Ashforth & Co., New York, N.Y.
Benenson Realty Company, New York, N.Y.
Bessemer Securities Corporation, New York, N.Y.
Boise Cascade Urban Development Corp., Washington, D.C.
Carol Management Corp., New York, N.Y.
Chase Manhattan Bank, New York, N.Y.
Chisholm Realty, Inc., New York, N.Y.
Arthur G. Cohen, New York, N.Y.
Collins, Tuttle & Co., Inc., New York, N. Y.
The George Comfort Co., Inc., New York, N.Y.
Cross & Brown Co., New York, N.Y.
Crown Realty Associates, Chicago, Illinois
Dillingham Corp., Honolulu, Hawaii
Benjamin Duhl, New York, N.Y.
The Durst Organization, New York, N.Y.
Eastman Dillon Union Securities & Co., Inc., New York, N.Y.
Fisher Brothers Management Co., New York, N.Y.
Galbreath-Ruffin Realty Co., Inc., New York, N.Y.
Goldman, Sachs & Co., New York, N.Y.
Gulf & Western Realty Corporation, New York, N.Y.
Helmsley-Spear, Inc., New York, N.Y.
Hilton Hotels, Beverly Hills, California
Irving Trust Company, New York, N.Y.
Kidder Peabody Realty Corporation, New York, N.Y.
Lazard Freres & Co., New York, N.Y.
Lehman Brothers, New York, N.Y.
Loeb, Rhoades & Co., New York, N.Y.
Loew's Theatres, Inc., New York, N.Y.
John P. McGrath & Sol G. Atlas, Brooklyn, N.Y.
H. J. & M. Minskoff Realty Corp., New York, N.Y.
Morgan Guaranty Trust Co. of New York, New York, N.Y.
Raymond D. Nasher Company, Dallas, Texas
Oestreicher Realty Corp., New York, N.Y.
Pearce, Mayer & Greer, New York, N.Y.
Rockefeller Center, Inc., New York, N.Y.
Rose Associates, New York, N.Y.
Arthur Rubloff & Co., Chicago, Illinois
Peter Sharp & Co., Inc., New York, N.Y.
Harry G. Silverstein & Sons, New York, N.Y.
Swig, Weiler & Arnow, San Francisco, California
Tishman Realty & Construction Co., Inc., New York, N.Y.
Uris Buildings Corporation, New York, N.Y.
Joseph S. Wohl, New York, N.Y.
Wood, Struthers & Winthrop, New York, N.Y.
William Zimmerman, New York, N.Y.
Affiliate: National Apartment Association, Washington, D.C.

APPENDIX 2

THE TAUBMAN-RASCHE STUDY

Taubman and Rasche define economic depreciation as the decline in the market value of the property. They then measure depreciation from a cross section of buildings, and their analysis therefore excludes the effect of changes in the general price level: for data from any one calendar year, general inflation affects equally the rentals and expenses for buildings of all ages. Since the present discounted value (PDV) profile is calculated from this cross section, its shape (but not its height) is unaffected by the general price level. (Of course, the successive PDV profiles calculated from data of different years will be different in height because of inflation.)

The failure of Taubman and Rasche to consider the effect of inflation is the first major defect in their study. As I explained in the body of my testimony, the Federal tax system causes inflation to have its most adverse effect on investments with relatively long lives, such as housing and nonresidential construction. Since the Taubman-Rasche study makes no allowance for this important effect of the Federal tax system, the study is at best of severely limited usefulness in guiding tax policy.

A second objection to the Taubman-Rasche study is that PDV is calculated according to a theoretical formula, and there is no reference to the actual movements of prices for used buildings of different ages. This formula makes no allowance for risk or uncertainty, and it is not clear how the formula values relate to the actual prices of used office buildings.

On a highly technical level, there are a number of very disturbing elements in the Taubman-Rasche study. A general observation is that the authors do not present an accurate or complete description of their technique, and it is thus very difficult to offer constructive criticism—all one can do is pose queries. Part of the problem is that I have been unable to obtain access to the authors' data in the time available, but I do feel that the authors would have added to the understanding of their study if they had made available a better description of their data base. Nonetheless, these points are in order.

(1) How does the sample of buildings change? Obviously newly built buildings are added, but are existing buildings ever removed, except when they are demolished?

(2) By looking only at existing buildings to calculate average rental rates, the authors introduce a bias. Those buildings whose rentals decline fastest should tend to be removed earliest, so that the cases where depreciation has been most rapid are not included in the sample. (Imagine taking a lifetime earnings profile by looking at a cross section of earnings by age, including only persons actually working. The effects of retirements and of age discrimination in employment would be suppressed.)

(3) The PDV profile depends very much on the shape of the rental curve given by the formula

$$R^*_j = a + b\,(\text{age } j)^3$$

However, the authors do not tell the statistical properties of the regression fit obtained from this equation, nor do they say whether they tried any other formulas, or what kind of fit other formulas might have given.

(4) The calculation of average age within groups introduces both uncertainty and bias. The uncertainty intrudes because the population of buildings from which age is calculated is not the same as the sample (which includes only *some* office buildings). The bias occurs because the authors assume, in calculating average age, that buildings are removed only exactly at the end of 10, 25, or 40 years, or after 60 years. In fact, the percentage of buildings still standing should decline gradually with age, and younger buildings cohorts in each age group should receive greater weight than older ones. Use of a flat amount of involuntary removal within each group biases the average age upward, and this understates the decline in average rentals with age. The result is to understate the rate of depreciation.

(5) To calculate removal date, the authors require estimates of land values (per square foot *of office space*). Whence these estimates (and what is their quality)?

(6) The authors neglect the effect of increases in building size, which causes (*ceteris paribus*) land cost per square foot of newly built office space to decrease over time. However, this effect is not present for an existing structure, whose size is fixed until the building is replaced. Failure to take account of this difference introduces an upward bias in the calculation of office building lives.

(7) The data are troublesome, especially when the rental rates for 0 to 10-year-old buildings are less than for 11 to 25-year-old buildings (1956 and 1957, in Table 3a). The authors explain that these years coincide with peak building construction and depressed rental rates for new buildings. However, this explanation is inadequate. The break in the time series is for the 11 to 25-year-old buildings (which rose in price), not for the new ones; and the operating costs (Table 3b) for the 11 to 25-year-olds also jumped in the same two years, leaving gross margins roughly constant. This suggests something else, like first appearance of 1945–1947 buildings in this group, plus shift of the 1930–1932 buildings to the next age group. If such shifts are so important, then perhaps the use of fixed age groups, with buildings moving through the groups, is questionable.

These seven points should indicate the basis of my grave doubts about the quality of the empirical work in the Taubman-Rasche study. This is especially so because all of the biases identified lead Taubuan and Rasche to find longer lifetimes and less rapid depreciation than is actually present. These biases, plus the two general objections stated at the beginning of this appendix, are my reasons for not accepting the analysis of Taubman and Rasche as controlling in the present situation.

The CHAIRMAN. Mr. Robert Pease who is vice president, Mortgage Bankers Association of America, accompanied by Oliver H. Jones, executive vice president, and Graham T. Northup, director, Government Relations.

STATEMENT OF ROBERT PEASE, VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA; ACCOMPANIED BY H. CECIL KILPATRICK, TAX COUNSEL; AND GRAHAM T. NORTHUP, DIRECTOR, GOVERNMENT RELATIONS

Mr. PEASE. Thank you, Mr. Chairman.

My name is Robert H. Pease. I am senior vice president of the Draper and Kramer Mortgage & Real Estate firm in Chicago, and vice president of the Mortgage Bankers Association of America. With me is Mr. Cecil Kilpatrick, our tax counsel, and Mr. Graham Northup, director of Government Relations.

We have filed a statement with the committee, and I would like to give you these additional observations.

The CHAIRMAN. Yes, sir; we have that statement here.

Mr. PEASE. We would like particularly, Senators, to talk to you not just from the standpoint of the mortgage bankers——

The CHAIRMAN. Your statement commences at page 197 of our committee print.

Mr. PEASE. Right.

We would like to talk to you not only from the standpoint of the mortgage banking business but particularly from the standpoint of how this tax bill will affect the housing program that the Federal Government is so urgently trying to foster. The experiences which I am giving you are the result of 35 years in the real estate and mortgage business.

Our firm has probably done more 221(d)(3), more low- and middle-income housing, over 4,000 units, probably well over $100 million, maybe more than any other firm in the country, so that I think the following observations are relevant to the program.

Statement No. 1: The idea that this tax reform bill will help the residential housing program, particularly low and middle income, I think, is absolutely and totally inaccurate. I think it is false. The bill says that new housing can keep its 200-percent depreciation. Then it immediately nullifies this entire provision and, I think, rules out any inventory participation by (*a*) recapturing all depreciation in excess of straight-line as ordinary income; (*b*), making the secondary owner of rental housing use straight-line depreciation the minute he buys this investment. This recapture method, I think, will totally force out the investor, and I am sure that it will ruin the resale market for rental housing. I think that it will ruin the entire housing program.

I would suggest that actually it will probably destroy the housing program. Investors are paying 9½ percent for mortgage money. They are paying 14 percent for construction loans. Labor is rising almost every month. Materials are going up every month.

Now, under these road blocks I don't believe the investors can or will participate in a housing program with the depreciation set up under H.R. 13270.

What do we suggest you do? What do we recommend? Our suggestion is totally unattractive to the speculator, certainly unacceptable to a tax dodger. We think it is fair to an investor and we think it is fair to the Government.

First, permit total recapture of excess depreciation during the first 5 years.

Second, after 5 years allow a reduction of percentage of gain taxed as ordinary income at the rate of 1 percent a month.

Now to sum it all up, this means that an investor would have to hold a piece of property 13 years and 4 months before he could get full capital gains treatment.

I am sure that this is unsatisfactory to any in-an-out operator or to any speculator. We think it will keep the private investor in the housing program.

Statement No. 2. There is another very difficult and extremely important faulty section in this bill. I think that it threatens the entire real estate market. That is the section which will force every buyer of used real estate, after July of this year, to use straightline depreciation. It eliminates 150 percent, and he must use only straightline. I think this will ruin your income property real estate market. I think every owner of real estate today will be forced into a severe loss position when he tries to sell his property because the new buyer must buy only under a straightline depreciation method.

Months ago we started talking about 154 millionaires and somehow or other we wound up writing a tax bill which, I think, is going to have a severe loss on the entire real estate holdings of millions and millions of people in this country. I don't think that is your intention, but it is in the bill.

Statement No. 3. There is nothing very complicated about taking care of the tax shelter abuses. It is done through the limited tax preference, presently in the bill. We endorse it. In fact, we testified before the House Ways and Means Committee earlier this year and endorsed the theory and the practice of limited tax preference.

Now somehow the concept has become current that millionaires are the bulk of the real estate owners in this country. Nothing could be further from the truth. The bulk of real estate owners are janitors, doctors, businessmen, retired investors, teachers, the whole investing public of this country.

If a thief ran down the street I don't think you would shoot him if a hundred people were on the street. Well, you are shooting at the millionaire and you are hitting the millions and millions of real estate investors in this country.

I don't believe that the purpose of this bill is to injure these people that are the present owners of real estate, but I assure you that is exactly what will happen.

We would urge you to leave existing real estate at 150 percent, stretch out your recapture to 13 years and 4 months and then you keep the investor in the program. Leave limited tax preference in, and you knock out the tax abuses. It gives the long-term investor a reasonable incentive to stay in the housing program.

I think that the bulk of the American investing public will be protected if you will leave 150 percent for used real estate, and gentlemen, that is absolutely essential to the housing program because no investor is going to go into a program when his resale market is totally and completely eliminated.

Again I am talking to you from 35 years experience in the business. We are dealing and have dealt for the past 12 years with investors that are going into housing programs, have gone into housing programs, and I think we understand to some degree what motivates them, what has motivated them. I assure you that every housing goal that Congress has set will be totally ruined by the effects of H.R. 13270. Client after client has said to us, in effect, "Why is Washington trying to ruin the real estate market? Why are they so hard on real estate in this tax bill?" I don't think that is the purpose. I think the purpose is to plug some very wide loopholes that have existed in our tax program. This you have done. Now the bill should be amended to give reasonable protection to the long-term housing investor.

I want to close the way I began. Our housing goals are deeply embedded in national policy that we should not and we cannot endanger them. Yet, H.R. 13270 does exactly that. We urge you to change the recapture provision to a 13 years and 4 months provision. We urge you to leave existing real estate at 150 percent. We endorse the principle of limited tax preference.

We think that H.R. 13270 can be a great instrument for tax reform and a great piece of legislation. I would urge you to make these amendments.

There are many other features of the bill about which we would like to have commented. We did not want to take your time. I would hope that you would read the testimony that we have filed. But, again, gentlemen, the housing program of this country is too important and too essential to be endangered by this bill. We urge its amendment.

Senators, thank you.

The CHAIRMAN. Thank you very much, sir.

Senator MILLER. May I ask one question, sir? It is a splendid statement. I have one question on a point you didn't cover. You recommend the LTP approach on capital gains, I am sure, but you didn't mention anything about the allocation of deductions, which, as you know, is one item in this bill that is advocated very strongly by the Treasury in support of the House treatment. What is your position on the allocation of deductions approach.

Mr. PEASE. Cecil, would you care to comment on that?

Mr. KILPATRICK. I am sorry, I am not familiar enough with that particular provision of the bill.

Senator MILLER. Would you care to supply a position on that for the record?

Mr. PEASE. We certainly will.

Mr. KILPATRICK. You have in mind particularly the depreciation?

Senator MILLER. No; I have in mind, I don't believe your statement covered the allocation of deductions provision of the bill and I am wondering what your position is on it.

The CHAIRMAN. I would say after your tax counsel explains to you how the allocation of deductions proposal will work you can comment on it.

Mr. PEASE. We will give you a statement on that, Senator.

The CHAIRMAN. Fine.

(Robert H. Pease's prepared statement follows:)

The statement referred to had not been received at the time of printing.

STATEMENT OF ROBERT H. PEASE, VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA

SUMMARY

1. The combined impact of the tax reform proposals contained in H.R. 13270 and the Treasury Department recommendations will strike a devastating blow at our construction industry by:

a. Making less mortgage money available and

b. Making equity investment in real estate unattractive.

2. Less mortgage money will be available because:

a. The bill in inflationary. Inflation makes long-term, fixed-dollar obligations unattractive except at prohibitively high interest rates.

b. The incentives to thrift institutions to invest in mortgages are reduced.

c. No tax is levied on the Federal Land Banks. The privately owned Federal Land Banks remain tax exempt driving taxpaying lenders from the agricultural loan market. This tax exemption is grossly inequitable and a disservice to farmers and ranchers.

3. Less equity money will be available for real estate projects because H.R. 13270 contains the following provisions which would reduce the ability to obtain a competitive profit:

a. The use of accelerated depreciation is restricted.

b. Available remaining excess depreciation is subjected to the Limited Tax Preference.

c. All excess depreciation allowed would be taxed at ordinary income rates at time of sale.

d. Capital gains rates would be increased.

e. Hobby loss limitations are reduced and extended to apply to any enterprise with a presumption that, regardless of the nature of the enterprise, there is no expectation of realizing a profit where such losses occur in three of a five-year period.

f. Deductions for interest on funds borrowed for a newly defined category of investment income, including rent under a net lease, would be limited.

4. In all, eight provisions of the bill, and one omission, are deterrents to realization of the urban and rural development goals the nation established in 1968.

5. Additionally, the provisions of Sec. 221 could impose a heavy tax—which was totally unforseen—on mortgage banking firms which already pay full corporate rates.

STATEMENT

Mr. Chairman, my name is Robert H. Pease. I am Senior Vice President of the Mortgage banking firm of Draper and Kramer in Chicago, Illinois and Vice President of the Mortgage Bankers Association of America. With me this morning are Mr. Graham Northup, Director of Governmental Relations for the Mortgage Bankers Association and Mr. H. Cecil Kilpatrick, the Association's tax counsel. We appreciate this opportunity to appear before this Committee to express our views on H.R. 13270 and other proposed tax reforms. To understand our interest in this legislation, it may be well for me to speak a moment explaining who our Association represents and what our members do.

The Mortgage Bankers Association of America (MBA), now in its fifty-fifth year, consists of more than two thousand members dedicated to the originating, marketing, servicing, and holding of real estate mortgage loan investments. These mainly include:

Mortgage bankers who engage directly in the origination, financing, selling, and servicing of real estate mortgage loans for others;

Investing institutions that acquire mortgage loans from mortgage bankers, including life insurance companies, commercial banks, mutual savings banks, savings and loan associations, fire and casualty insurance companies, investment funds, pension funds, and similar institutions.

At the end of 1968, mortgage company members of the Association were servicing approximately $69 billion of mortgages. Of this, $52 billion consisted of mortgages on single-family properties, somewhat more than 20 percent of all outstanding home mortgage debt.

As originators of home mortgage loans, mortgage bankers have been major supporters of the Federal government's mortgage programs. However, mortgage bankers' interests extend into all fields of mortgage finance: residential, commercial, industrial, agricultural, and institutional. In recent years, mortgage banker members of the Association have accounted for nearly one-fourth of the net increase in the outstanding dollar amount of mortgages on apartments and other types of income-producing property.

As real estate investors we have perhaps been closer to, and therefore more concerned with, urban problems than have many others. We have lived with the developing problems, seen them grow, and seen them culminate in riots and disorders. We know only too well the vital role an adequate supply of mortgage funds can play in alleviating urban pressures and redeveloping our urban and rural areas. Through the years, Congress has sought to assure funds through direct grants as well as through a proliferation of other measures most of which failed because the magnitude of the demand exceeded available Federal resources. During 1967 and 1968 the Senate Banking and Currency Committee and a series of Presidential Commissions engaged in comprehensive reviews of previous programs. In the housing bill of 1968, new goals were established and new directions ordered for our urban development efforts. Reliance on Federal resources was minimized. The new programs sought to tap the wealth of our private sector by encouraging its maximum participation in urban investments. Because this legislation contemplated maximum results with a minimum cost to the Federal government, it was wholeheartedly welcomed by the Congress and the nation. Hope was rekindled in millions that we might now move ahead in our urban efforts unhampered by the limitations of Federal appropriations and red tape but encouraged by Federal guidance and Federal tax incentives. H.R. 13270, if enacted in its present form, will dash those hopes.

H.R. 13270 would reduce the availability of mortgage money

We are concerned about the impact of H.R. 13270 on the overall availability of mortgage funds and the possible distortions that its enactment could have on the use of those funds which are available. Thus, our concern is two-fold. The proposed tax reforms may unnecessarily discourage the flow of funds for mortgages and encourage the use of these funds in other fields. They may also distort the employment of the mortgage funds remaining by over-encouraging some forms of real estate improvements, such as residential, to the detriment of well-balanced development including necessary commercial.

H.R. 13270 is inflationary

Because as early as 1965 we recognized the threat which inflation posed to an adequate continuing flow of mortgage funds, the Mortgage Bankers Association since 1965 has urged fiscal and monetary policies to restrain inflation. We continue firm in our belief that *unless inflation is controlled, there is no hope for an adequate supply of funds or any retreat from the record high interest rates which now prevail.* If we can depend upon the Treasury's projections which have been made for H.R. 13270, we must conclude that its thrust is inflationary. The responsibility rests with the Congress to strike the appropriate balance between the proposed reduction of incentives for industrial investments and the proposed reductions in individual income tax, but we urge the Committee's careful reconsideration of the revenue projections and the proposed tax reductions to the end that the risk of further inflation will be eliminated.

We have attached for inclusion in the record the September issue of *The Capital Goods Review* of the Machinery and Allied Products Institute entitled "Effects of Inflation on Lenders and Borrowers." This article points out most dramatically the effects of taxes and inflation on the returns that are realized on fixed long-term obligations. For example, it notes that the true economic return to a lender in the 20% tax bracket on a loan made at 8% during a period when the rate of inflation equals 5% would only be 1.33%. Put another way, it shows that under the same circumstances if the lender wished to realize a true 5% return on a loan, it would be necessary to charge the borrower 12.81% of interest. Such rates on mortgages would be illegal in many states and offend the public conscience anywhere. It is obvious why mortgages are unattractive investments in periods of inflation.

Though it may be trite to say so, inflation is the cruelest tax of all. It is no service to the voter to hand him a tax reduction in one hand and take it back in inflation. If inflation is allowed to continue, mortgage funds will continue in short supply and then only at a high cost.

Incentives for thrift institutions to invest in mortgages are reduced

Proposed tax revisions can also affect the flow of mortgage funds if they remove incentives for financial institutions to invest in mortgages. Various proposals have been offered for changes in the tax treatment of mutual savings banks, savings and loan associations and, commercial banks. Sections 441 and 442 of H.R. 13270 modify the existing provisions regarding deductions for additions to reserves and requirements respecting the percentages of assets which must be invested in residential mortgages to be eligible for such deductions. The Treasury has suggested, instead, an across the board deduction of 5% of gross interest income derived from mortgages for all banking institutions, subject to certain limitations. Mortgage Bankers pay regular corporate tax rates and are not directly affected by these proposals. However, the testimony of the affected institutions,* to whom we customarily sell mortgages, discloses that *either proposal will have an adverse effect on the flow of mortgage funds at a most critical time.*

The official housing goals for the next decade are well known. Less well publicized are the various studies that have been made on the outlook for mortgage funds during the next decade. These studies, made prior to any suggestions for reduced tax incentives for mortgage investment, range in their conclusions from predictions of tightness to emphatic warnings of critical shortages. None of these studies projects a surplus of credit.

Therefore, we urged the committee to give the most serious and careful study to these proposals. Commercial banks and mutual thrift institutions were created for different purposes and continue to carry out basically different roles in our economy. It is not as important to achieve tax equality between them as to assure their continued ability, and desire, to carry out their historic functions. Reducing the incentives to invest in mortgages for institutions which have traditionally been primary sources of mortgage funds is not desirable at this time.

No tax is levied on the privately owned federal land banks

In this regard the Mortgage Bankers Association urges that you enact legislation to subject the Federal Land Banks to a fair tax. Few realize that these institutions were granted complete exemption from all taxation when created in 1916 and continue to enjoy this tax-free status despite the fact that they have been wholly privately owned since 1954—and that they compete directly, forcefully, and effectively with private taxpaying lenders. Allowing the Federal Land Banks to continue wholly free from Federal, State, and local taxes is a glaring example of legislative oversight which sorely needs correction if we truly seek equity in taxation. A study of this question is attached with the request it be included for the record. We also attach a copy of H.R. 9242 as suggested legislative language to end this unfair tax exemption.

Basically we are concerned that *H.R. 13270 will constrict the availability of mortgage funds* because it is inflationary, because it makes mortgages less attractive as an investment for financial institutions and because, by failing to impose a fair tax on the Federal Land Banks, it drives other lenders from the Agricultural loan field.

Less equity capital will be available for real estate

The bill will also have a serious impact on our efforts to stimulate equity investment in real estate. The existing provisions of law regarding real estate depreciation and capital gains have proved to be effective incentives for equity investment in all forms of real estate development. At this point we think it matters very little that they may not have originally been enacted for this purpose. We have all heard of the tremendous tasks facing us if we are to create a suitable living environment in our nation. Creating such an environment is not solely a question of building housing—and certainly not solely a matter of low- and moderate-income housing. There must also be factories, warehouses,

*National Association of Mutual Savings Banks, September 15, 1969. National League of Insured Savings Assocations, September 15, 1969. United States Savings and Loan League, September 15, 1969. Council of Mutual Savings Institutions, September 15, 1969. All before Senate Committee on Finance during hearings on H.R. 13270.

stores, churches, schools, gas stations, highways, sewer and water systems and all of the other improvements and services which go to make up the living environment. This will require tremendous investments of savings, and unless those investments can be generated from the private sector, the burden will fall increasingly on government. Despite any impressions to the contrary, real estate ventures involve a high element of risk. Many go broke. Very clearly, private capital will be drawn into investments which provide the largest after tax profits. Existing tax incentives are essential to continue to draw private capital into housing and commercial properties.

How, you may ask, would a project sponsor obtain what he considers an adequate profit in the absence of tax incentives? The only answer we know is that he would have to increase the direct return from the project by increased charges to the occupant or occupants. But look at what has happened, for instance, in the urban apartment market. Land costs have sky-rocketed. Materials, labor, mortgage money and all the other components of construction have climbed sharply. The result is that even with the present tax incentives, it is virtually impossible to construct new apartments that low income families can afford. In many of the higher cost areas you cannot build for the middle income people—which means people earning up to $10,000.

Let me give you an example. About four years ago our firm built an apartment building with monthly rents that averaged approximately $53 per room. We owned some additional land adjoining this project and we recently considered building another building adjacent to the existing apartment project. As we already owned the land, the increase in land value did not really affect our decision. We figured current construction costs of the new building, ascertained our new interest cost and gave up the project. We would have had to rent the new building for $75 per room. We felt this was too risky. Even with accelerated depreciation, we were unwilling to build the apartment.

If existing tax incentives were removed, it would be necessary to increase rents even further, which would inevitably result in construction being undertaken only for the most affluent. Lacking a demand from affluent tenants, no construction would be done and available capital would flow to other fields.

Income properties erected for business occupancy contain an even higher element of risk. Particularly is this true of those designed to serve the small businessman. Neighborhood merchants, the "mama and papa" stores, throughout the nation have long protested that urban renewal is putting them out of business because they cannot afford the rents in the new space made available after old stores are torn down. Without tax incentives their rents would be even higher.

H.R. 13270 would allow accelerated depreciation only for new residential structures. Under this condition equity capital for business structures would be non-existent, except of course for the larger more credit-worthy corporation.

We do not concur with the administration position, as expressed by Assistant Secretary Cohen in his appearance before you on September 4th (Sec. 25), that the proposed changes in real estate depreciation and capital gains are either appropriate or are consistent with the achievement of our housing goals; nor are we "Concerned with the continued heavy reliance upon tax incentives" as a means of achieving those goals. May we remind this Committee that for several years the housing and home finance industries, the Department of Housing and Urban Development, and the Congress itself have concerned themselves with questions about tax incentives to further stimulate urban development. Any number of bills are introduced each year proposing new incentives. In 1967 the Senate Banking and Currency Committee asked us informally for suggestions for any needed new incentives. Other Senate committees have held hearings on bills for this purpose, specifically those introduced by the late Senator Robert Kennedy. After much study, it was concluded that existing incentives would suffice if a broader range of investors were encouraged to use them. Consequently, Congress passed a bill last year authorizing the creation of a National Corporation for Housing Partnerships to spread the word and attract new investors. Notwithstanding the Treasury's concern, the Congress has acted—it wants these tax incentives utilized.

Limited tax preference

Why then do we now sek to eliminate most tax incentives and reduce the others? The answer is, very simply, because a smokescreen of 154 wealthy non-taxpaying citizens has been thrown up to cloud the voters' view of this picture. Surely, these wealthy people should pay a fair share of taxes. The Limited Tax Preference, which we strongly support, would assure that they would.

Limited Tax Preference as originally proposed—that is, including income other than that sheltered by depreciation—should be enacted. To do so would be fair and equitable. These 154 people represent only one percent of the taxpayers in the $200,000 and over tax bracket, and we should not eliminate badly needed tax incentives in a hasty effort to respond to public indignation about them.

The Administration urges enactment of some of these proposed reforms in order to maintain the level of Federal revenue for some future unspecified plan of Federal Revenue Sharing. We submit that the present incentives are an effective means of accomplishing that objective. For example, assume we create a property valued at $1,250,000. Further assume the land is worth $250,000 so the depreciable improvements are valued at $1,000,000. Using the double declining balance method, first year depreciation would be $40,000. This means the U.S. Treasury would lose $20,000 of revenue that it might have received if depreciation is limited to straight line. We say "might have received" because it is our experience that many of these projects would not be built without the present tax incentives. Tax authorities tell us that local real estate taxes average 2% of value, which means this project would generate $25,000 of income for the local community the first year. Further, the Federal revenue loss would diminish each year while the local revenue would probably increase, or at worst remain stable. In other words, the *Federal tax incentives for real estate investment directly benefit local communities in an amount which exceeds the Federal revenue loss*. This revenue sharing plan is in operation now.

Let me cite a few examples of how this has worked in my home town of Chicago.

Ten years ago, the area from the 31st to 28th Street and South Parkway in Chicago was one of the worst sections of the city. Few if any taxes were being paid. Most of the buildings were in virtual shambles. It was one of the worst slums in the city. Today this area is one of the fine residential sections of the city with a waiting list for apartments in each of the five multi-story buildings that were built there. This is the site of a project know as Prairie Shores. There are 1700 apartments; the occupancy is 80 percent white, 20 percent non-white and we have not had a vacancy for as long as I can remember. When this project was built, the risks connected with it were very great, and it was extremely difficult to induce people to put equity into the deal. I can asure you that one brick would never have been laid on another without accelerated depreciation.

The benefits to the city of Chicago from this project are almost incalculable. Michael Reese Hospital, which is one the city's finest institutions, was considering moving; they have stayed. Virtually no real estate taxes were being paid on the property. In the last 10 years, regular tax bills have been paid. The entire area has been completely transformed into a community with new housing and new values.

Just a few blocks south of Prairie Shores is the development known as South Commons. It is located in and around 29th Street and Michigan Avenue. It is composed of low-and moderate-income housing projects insured under sections 220 and 221(d)(3) of the National Housing Act. The total investment in this project will be approximatey $20 million. Parts of it have already been built, and construction is proceeding on the balance. I talked with the firm of Baird and Warner, which is the managing partner for the group that runs this development. They said that it would never have been built without accelerated depreciation nor would it have been built without Prairie Shores which was in turn built because of accelerated depreciation.

Sandburg Village is a relocation housing project built under Section 220 of the National Housing Act containing approximately 2600 apartments at North Avenue and LaSalle Street in an urban renewal area of Chicago. This project was developed by Dovenmuehle, Inc. I talked to Mr. Buenger, the President, and he told me that without accelerated depreciation this project would never have been started nor the subsequent addition made. Again, this type of development has changed the entire community. It has brought real estate taxes to the municipality both from the specific project and from the other improvements that have been made because of the change in the neighborhood.

We are most anxious to impress upon you the fact that benefits of accelerated depreciation are very large both to a community and to the general real estate market. These benefits are difficult to measure in dollars, but they are sizeable. I have cited to you three specific examples of areas in Chicago which benefited from real estate development made possible because of accelerated depreciation. The changes brought about by the investment in these projects have completely reversed the real estate market that existed in these areas. Equally important, they have completely reversed the real estate tax base, which was almost totally zero, and have made these areas major real estate taxpayers. The building of these projects has brought other investments into the community, and these in turn have further added their benefits to the areas. We strongly urge you to think of accelerated depreciation as a vehicle for the upgrading of our communities, the building of billions of dollars of new real estate improvements, and the creation of values in our country which are indispensable both for housing people and for buttressing our economy.

Capital gains

It is important to understand that accelerated depreciation and capital gains treatment must be viewed as one when discussing incentives for real estate investment. Allowing excess depreciation but recapturing all excess depreciation at ordinary income tax levels at time of sale merely delays the tax. *The incentive is not in delaying the tax but in increasing the likelihood of return of the investment.* If the investment is to be meaningful, there must be an opportunity to retain the gain. Under Section 521 of H.R. 13270 the present recapture formula (Sec. 1250) would be eliminated. We urge this not be done. We do, however, concur that a modification providing for full recapture of the excess in the event of a sale during the first five years with 1% allowed for each month the property is held thereafter would be acceptable. This would permit the investor who holds a property 13 years and 4 months before selling to pay only the capital gains rate on the amount received over the depreciation value.

Surely, if Limited Tax Preference is enacted and the capital gains recapture formula recast in this fashion, accelerated real estate depreciation can no longer be abused to escape the payment of income tax. Additionally, H.R. 13270 proposes an increase in the capital gains rate.

Section 213 hobby losses

Section 213 of H.R. 13270 broadens the so called "Hobby Loss" provisions by deleting the reference to "individuals" and substituting "taxpayers." Thus, it seems that Section 270 would henceforth apply to corporations. Furthermore, Section 270 has been broadened in its application so that it would now appear to include real estate transactions. While this may never have been intended, it could have serious repercussions in the real estate field, and we urge that it be amended so that it will not apply.

Under a number of the Federal Housing Administration's multi-family housing programs, maximum loans can be as high as $12,500,000. Obviously multimillion dollar projects are a long time in the construction period, two years is not unusual, and it ordinarily takes from 12 to 24 additional months to reach a break-even occupancy level. In other words, there can be three or four years of heavy losses in every large project even though no excess depreciation is used. If Section 213 of H.R. 13270 is enacted, it would mean that every project sponsor would face the task of negotiating with the Internal Revenue Service to overcome the presumption that there had been no expectation of realizing a profit. To create such an impediment to investment is totally unreasonable.

Section 221

Section 221 of H.R. 13270 would limit interest deductions for funds borrowed for investment purposes. It would also broaden the present definition of investment income to include certain forms of rental income.

This represents still another deterrent to investment in real estate and would be particularly harmful to those forms of real estate such as shopping centers customarily occupied on a net lease arrangement. In its present form we consider this Section vague and ambiguous. Assistant Secretary Cohen has stated in his testimony that it fails to correct the problem to which it was addressed and has recommended against its enactment. We concur in his view, for this provision would cause serious disruptions for mortgage bankers on two counts.

Mortgage lenders selling loans to the Federal National Mortgage Association (FNMA) are required to purchase FNMA stock in a specified amount for each loan delivered. In order to retain the servicing on these loans (for which a servicing fee is paid) the seller is prohibited from selling this stock. The stock is therefore effectively restricted. Mortgage bankers sell large quantities of home loans to FNMA. So much in fact, that many find a very high percentage of their capital and surplus tied up in this stock and, to obtain working capital, have had to borrow funds pledging the stock as security. It is clear enough to us that such borrowings are for business purposes—for our business is making and servicing loans—but we find the language of H.R. 13270 far from clear in its definition of the difference between "investment" and "business" purposes. At least one recent court decision (Leslie, et al. v. Commissioner, CCA-2, 69-2 USTC P 9540) further clouds the distinction. Should Section 221 be enacted, it seems clear that our presently allowable interest deductions would be challenged—and very likely denied. We foresee years of litigation before a clear decision is reached.

We are certain that this result was not contemplated when the language of Section 221 was drafted. Mortgage bankers have never to our knowledge been accused by anyone of paying less than their fair share of taxes. The stockholding requirement was authorized by the Congress to expedite the rapid transition of FNMA from Federal to private ownership. To deny the industry the deduction of interest on funds borrowed to offset the burden of holding this stock is not only grossly unfair but would serve effectively to thwart Congress' own expressed desires.

We oppose the enactment of Section 221 not only because of the impact on our business but because:

1. It would seriously impede the needed construction of shopping centers and other business structures under normal and customary financing arrangements. (It should be noted that construction may take a year or more. Section 221 is not clear but is subject to the construction that all interest paid or accrued during that period would be disallowed as a deduction.)
2. It is based on a completely fallacious assumption that the purpose of the borrowing is to acquire property to be sold at capital gains rates later, rather than to produce rental income.
3. To equate the case of one who borrows money to buy low yield stocks, and who therefore is a purely passive investor, with one who borrows to buy or build rental property which will bring in a good yield to justify the investment, is unsound. Therefore we urge that Section 221 not be enacted.

Conclusion

We hope to make one point above all others perfectly clear. *The combined impact of the tax reform proposals contained in H.R. 13270 and the Treasury Department recommendations will strike a devastating blow at our construction industry.* We are absolutely convinced that the House of Representatives was not aware of all the implications of the various individual proposals in H.R. 13270 and had very little understanding of the effect which they would have on real estate investment when considered in their totality. May we just review these in closing?

A. Mortgage funds will be less plentiful because:
1. The legislation is inflationary.
2. Savings and thrift institutions' incentives to invest in mortgages are diminished.
3. The privately owned Federal Land Banks remain wholly tax exempt, driving tax paying lenders from competing for agricultural loans. This tax exemption is grossly inequitable and a disservice to farmers and ranchers.

B. Equity capital is discouraged from the real estate field because:
1. Excess depreciation is denied or reduced.
2. Available remaining excess depreciation is subjected to Limited Tax Preference.
3. All excess depreciation allowed would be taxed at ordinary income rates at time of sale.
4. Capital gains rates would be increased.
5. Hobby loss limitations are reduced and extended to apply to any enterprise with a presumption that, regardless of the nature of the enterprise, there is no expectation of realizing a profit where such losses occur in three years of a five year period. Deductions for interest on funds borrowed for a more broadly defined category of investment income would be limited.

We urge the Committee to consider the combined impact of these various proposals on real estate investment. Although it is right and proper for all citizens to pay a fair share of tax, we should not forget, under the pressure of public indignation over the few who have avoided income taxation, that this nation has developed to its position of world leadership because of a strong and vibrant economy solidly based on the profit motive. The very citizens who are momentarily indignant enjoy the highest standard of living in the world because we have encouraged venture capital. To solve our major domestic problems we must continue to encourage massive investments in real estate development over the next decade.

Capital Goods Review

MACHINERY and ALLIED PRODUCTS INSTITUTE

NO. 79 1200 EIGHTEENTH STREET, N.W., WASHINGTON, D.C. SEPTEMBER 1969

EFFECTS OF INFLATION ON LENDERS AND BORROWERS

There has been a good deal of comment of late about "astronomical" interest rates. While it has been generally recognized that they are in part a response to the prevailing inflationary anticipations (borrowing is made more attractive by the prospect of repayment in cheaper dollars, lending less attractive by the prospect of receiving such dollars), there has been too little discussion of the degree to which they actually reflect and conform to these anticipations. Will the present level of rates maintain *real* lender returns and borrower costs at the level that would obtain without inflation?

This question is obviously unanswerable as stated, since it turns on an unknown: the amount of inflation anticipated. No doubt this varies widely from one forecaster to another, but the real question is how much is being discounted by the *market*. This would have to be inferred from the difference between the present interest-rate level and the one that *would* obtain in the absence of inflationary expectations. Since the latter is indeterminate (history does not disclose alternatives), the inference would be dubious, if not entirely useless.

It is possible, however, to explore the impact of inflation on lender returns and borrower costs by means of hypothetical cases, and to draw some inferences for the present situation. This we propose to do. We shall first work through a simple, round-number example and then give the results for a reasonable range of assumptions.

Example

Suppose a loan of $1,000 with interest at 10 percent payable annually is made by an investor in the 40-percent income-tax bracket. Suppose further that the inflation rate is 5 percent per annum. At the end of the year, he harvests $100 in interest, of which the Treasury takes $40, leaving $60 after tax. In view of the 5-percent inflation rate, however, it requires $1,050 at the end of the year to equal in real terms the $1,000 invested at the beginning. This means that he has to reinvest $50 of his after-tax interest receipts to maintain the integrity of his principal, leaving only $10 of real income. But even this is in year-end dollars, which are smaller than the dollars of investment. In terms of the latter, he has $9.52, and a true rate of return of 0.95 percent. This from a lending rate of 10 percent! [1]

Now look at the same transaction from the side of the borrower. Having borrowed the equivalent of 1,050 year-end dollars, but owing only $1,000, he has in effect had a reduction of real indebtedness by 50 such dollars, and a transfer to equity of that amount. Subtracting this gain from the $100 year-end interest payment, he has a net cost of $50, equivalent to $47.62 in the dollars borrowed, a rate, therefore, of 4.76 percent.

Tax Aspects

The spread between the real *return* to the lender after allowance for the erosion of principal from inflation (0.95 percent) and the real *cost* to the borrower after allowance for the gain to equity from the same cause (4.76 percent) is due, of course, to the difference in the tax treatment of the two sides. Interest receipts are taxable, interest payments deductible.[2] For a *nontaxable* lender, the return would equal the borrower's cost.

[1] The result is independent of the duration of the loan, as may be confirmed by converting the lifetime flow of after-tax receipts into the dollars of investment and solving for the implicit return.

[2] Because of their deductibility, the borrower's cost is independent of his tax status. See "The Cost of Borrowed Capital," *Review* No. 78, June 1969.

There is an obvious anomaly here in the treatment of inflation effects. The $50 that the lender must set aside at year-end to offset the *loss* of his real principal is taxed as income. On the other hand, the $50 *gain* to equity from the reduction of the borrower's real liability is untaxed (deductible as a cost). Clearly this is topsy-turvy. The loser pays and the gainer gets off free.

If the burden were reversed, the lender being granted deductibility for his capital loss and the borrower taxed on his gain, the picture would be rather different. Assuming, for example, a 40-percent tax rate on both sides, the lender's real return would be 2.86 percent instead of 0.95.[3] The borrower's real cost, on the other hand, would be 6.67 percent against 4.76.[4] But since the effect of inflation is ignored for tax purposes, this calculation is of course purely academic.

Lender's Real Return Over a Range of Cases

The foregoing example assumes a single inflation rate, a single interest rate, and a single tax rate. Similar calculations for a range of rates are shown below.

Lender's Real Returns for Various Inflation, Lending, and Tax Rates[a]

Tax Rate (Percent)	Inflation Rate					
	3 Percent			5 Percent		
	Lending Rate (Percent)			Lending Rate (Percent)		
	6	8	10	6	8	10
0	2.91	4.85	6.80	0.95	2.86	4.76
20	1.75	3.30	4.85	−0.19	1.33	2.86
30	1.17	2.52	3.88	−0.76	0.57	1.90
40	0.58	1.75	2.91	−1.33	−0.19	0.95
50	0.00	0.97	1.94	−1.90	−0.95	0.00
60	−0.58	0.19	0.97	−2.48	−1.71	−0.95
70	−1.17	−0.58	0.00	−3.05	−2.48	−1.90

[a]Assumes interest paid annually.

A quick glance at this table suffices to show the effect of even moderate inflation rates on the real returns of lenders subject to income tax. With a 3-percent inflation, a lender in the 30-percent tax bracket gets a real after-tax return of only 3.88 percent from a 10-percent loan rate. With a 5-percent inflation, he gets 1.90 percent. If his tax bracket is 50 percent, his returns are 1.94 percent and zero, respectively. The double tax-and-inflation bite is obviously devastating.

It may be interesting to show these results in a different form. Instead of solving for the real after-tax returns from various combinations of factors, suppose we solve for the lending rates required to yield specified returns. These appear in the next table.

Lending Rates Required To Yield Specified Real After-Tax Returns With Various Inflation and Tax Rates[a]

Tax Rate (Percent)	Inflation Rate					
	3 Percent			5 Percent		
	Required Real Return (Percent)			Required Real Return (Percent)		
	3	4	5	3	4	5
0	6.09	7.12	8.15	8.15	9.20	10.25
20	7.61	8.90	10.19	10.19	11.50	12.81
30	8.70	10.17	11.64	11.64	13.14	14.64
40	10.15	11.87	13.58	13.58	15.33	17.08
50	12.18	14.24	16.30	16.30	18.40	20.50
60	15.23	17.80	20.38	20.38	23.00	25.63
70	20.30	23.73	27.17	27.17	30.67	34.17

[a]Assumes interest paid annually.

Here the picture is, if anything, even more striking. To get a real after-tax return of 5 percent, a lender in the 30-percent tax bracket needs a loan rate of 11.64 percent with a 3-percent inflation and 14.64 percent with a 5-percent inflation. If his tax bracket is 50 percent, he needs 16.30 and 20.50, respectively. Even for a real return of only 3 percent, he needs loan rates of 8.70 and 11.64 percent if he is in the 30-percent tax bracket and 12.18 and 16.30 percent if he is in the 50-percent bracket.

[3] The lender's tax would be $20, leaving $80 after tax. Subtracting $50 for capital erosion, we have $30 (year-end), equivalent to $28.6 in the dollars of investment.

[4] With $50 of the borrower's interest payment taxable, he would pay $120 (100 to the lender, 20 to the Treasury). Subtraction of the $50 capital gain leaves $70 (year-end), of which the investment-dollar equivalent is $66.7.

Cost to Borrower

As indicated earlier, the real cost of debt to the borrower is reduced by the shrinkage of his obligation through inflation. It is the *excess* of the interest payment over this shrinkage.

Since interest cost is deductible, hence independent of the borrower's tax rate, this eliminates one of the variables that must be taken account of on the lender's side, leaving only the inflation and lending rates. If we assume the same values for these rates as before, we get the following:

Borrower's Real Costs for Various Inflation and Lending Rates

Lending Rate (Percent)	Inflation Rate 3 Percent	Inflation Rate 5 Percent
6	2.92	0.95
8	4.86	2.86
10	6.80	4.76

As we indicated earlier, the reduction of the borrower's real cost by inflation is less drastic than the reduction of the lender's real return. Thus, for example, a 5-percent inflation reduces the cost of a 10-percent loan to 4.76 percent, while reducing the real after-tax return to 1.90 percent for a lender in the 30-percent tax bracket and to zero for one in the 50-percent bracket.

The Present Situation

If we take the present inflation rate as 5 percent (recent figures make it even higher), it is evident that current lending rates leave most creditors with net losses in real terms. An 8-percent bond returns less than nothing net to a taxpayer in the 40-percent bracket, as does a 6-percent savings and loan account to one in the 20-percent band. A first-bracket (14-percent) taxpayer is substantially in the red on a 5-percent certificate of deposit; so too, of course, is a nontaxable lender on a 4-percent passbook account.

The Department of Commerce reports "total net public and private debt" of $1,569 billion at the end of 1968. At a 5-percent inflation rate, the shrinkage in the real value of this body of obligations is nearly $80 billion a year. When we consider that the bulk of them bear interest rates well below the current level, this annual erosion is almost certainly in excess of the collective after-tax interest yield to the ultimate beneficiaries (the individuals who benefit either directly or as claimants against financial intermediaries).

It is evident from our earlier table on lending rates required to yield specified real after-tax returns that with a 5-percent inflation and present tax rates there is little possibility of getting a significant real return even from the "astronomical" interest rates now prevailing on new loans. Even if the inflation rate were cut to 3 percent, a modest return would still require higher-than-present rate levels for most lenders and institutional creditors.

Here is the "euthanasia of the rentier" with a vengeance. The stagnationists who espoused this phrase were thinking of a *decline* of interest rates toward zero; the euthanasia now in process is occurring at the highest levels in memory. Inflation is accomplishing what "economic maturity" never did.

The question naturally arises why individuals persist in lending funds either directly or to financial intermediaries at rates that yield negative real after-tax returns. The answer is complex. Many do not fully realize the extent to which their capital is being eroded. Others who understand are at a loss to know what to do about it. Smaller savers particularly are accustomed to accumulate capital in dollar form—life insurance, time deposits, savings and loan shares, savings bonds, etc. While they may acquire a house and consumer durables for their own use, or invest in their own business, impersonal inflation hedges such as common stocks and income real estate are often outside their experience, and even when not are likely to be unsuitable to the purpose for which the dollar assets are held. Whatever the reasons—ignorance, habit, convenience, security—attachment to such assets is not easily dislodged.

It is an interesting speculation how a long-continued inflation at the present rate would affect this behavior pattern. What would it do to the structure of the capital market? How would it affect financial intermediaries? To what extent would creditor-protection devices be applied, such as price-level escalation, equity participation, etc.? These and similar questions are easier to ask than to answer. In any case they are beyond the scope of this essay. It is to be hoped, certainly, that inflation will be brought under control before they are answered by events.

MORTGAGE BANKERS ASSOCIATION OF AMERICA, JULY 31, 1969

THE FEDERAL LAND BANK SYSTEM AND TAX EXEMPTION

When the Federal Land Bank System was created in 1916, it was granted exemption from all taxation. At that time the composition of the agricultural economy and the character of the financial institutions which served it were vastly different from what they are today. In the fifty-three years since, these conditions have changed, but, to the best of our ability to determine it, the appropriateness of the tax exemption has never been reconsidered. We believe the exemption should be repealed.

Changes in the Agricultural Economy

The total number of farms in the United States has been declining, almost without interruption, since the time the Federal Land Bank System was created. According to the 1920 Census, there were over 6.5 million farms in the country with an average size of 148 acres. By 1940, this number had declined to about 6.4 million, and between that year and 1959, it dropped nearly 36 per cent to 4.1 million, while average acreage rose from 167 to 288. In the ten years since then, the number of farms has slipped to about 3.0 million and the average acreage has risen to about 380.[1]

Although the amount of cropland has been declining, the reduction in harvested acreage has not been as great as the above figures might suggest. What has been happening, as these data indicate, is that smaller farms have been disappearing as economic and technological changes dictate larger units.

Harvested acreage declined only 7 per cent betwen 1920 and 1959 to a total of 458 million acres. It is estimated to have dropped another 20 million acres between 1959 and 1961. "Estimates indicate that (if trends in yields since 1950 continue) the food and fiber needs of a population that may be 45 per cent higher by 1980 could be met with 407 million acres of cropland compared with 458 million acres in 1959." [2]

Statistics on numbers of farms of various sizes confirm the fact that the remaining farms are growing larger. Between 1940 and 1959, the number of farms of 100 acres or less declined 52 per cent from about 3.6 million to 1.7 million. In this same period, the number of farms of 260 acres or more increased from 724,000 (.7 million) to 808,000 (.8 million). There was a 35 per cent increase in the number of farms of 1,000 acres or more while the number of farms in all size categories under 260 acres showed a decline.[3]

The changing farm economy and the sharply expanded opportunities for employment in the cities have brought a dramatic decline in farm population. In the short span of 17 years between 1950 and 1967, farm population dropped 53 per cent from 23,048,000 to 10,817,000. Between 1920 and 1967, farm population declined from 30.1 per cent of total U.S. population to 5.5 per cent. In 1966 alone, farm population dropped another 6 per cent in number and its share of total population shrank to 5.9 percent.[4]

Despite these declines in the number of acres harvested, in the number of farms, and in farm population, agricultural production has not declined. According to the Federal Land Banks, "* * * man hours worked in farming have dropped 60 per cent during the past quarter century—yet total farm output rose to 63 per cent, dramatically emphasizing the substitution of capital for labor." [5] Fifty years ago, one farm worker produced food and fiber for eight people. Today, he can produce enough for 37. Put another way, one hour of farm labor yields more than five times as much food and other crops as it did a half-century ago.[6]

Furthermore, even with the decreasing numbers of farms, more farms have sales of $25,000 and over than was true in 1950, the first year in which such data were collected. (No inflationary factor is involved here, since the index of farm prices received has actually decreased in the period.) Between that year and 1964, the number with sales of this magnitude has more than tripled, from about

[1] Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States*, 1968, p. 594.
[2] *The Yearbook of Agriculture*—A Place to Live, 1963, U.S. Department of Agriculture, p. 63.
[3] Census, op. cit., p. 596.
[4] Department of Commerce, Department of Agriculture, Current Population Report, *Farm Population*, Series Census-ERS P-27, No. 39, May, 1969.
[5] Advertising supplement to *American Banker*, op. cit., p. 2.
[6] Ibid., p. 1.

103,000 to 337,000, and the proportion of this group to all farms has risen from 2 per cent to 11 per cent. At the same time, the number with sales of under $2,500 has dwindled from 1.6 million to about 350,000 and their proportion from 30 per cent to 11 per cent. (See Table I–A.)

Crucial in this context is the trend away from the individually owned farms, of whatever size, toward a more complex, corporate structure. The step-by-step liberalization of the eligibility requirements of the Federal Land Banks to include corporate borrowers speaks as eloquently as would any data on this subject, were they available.

Changes in the agricultural economy

Furthermore, while the economy it served was in transition, the Federal Land Bank System itself has been undergoing change—in aim, in organiaztion, and in market served.

While the reasons for creating a special credit structure for farm finance are not explicitly stated in the statute creating the Federal Land Bank System, the Farm Credit Administration has, over a long period, offered this definition of purpose:

"This System was created by Congress to meet a definite economic need for a permanent and dependable source of sound farm mortgage credit at reasonable rates and on terms especially adapted to the particular requirements of farmers. It was expected that this farmer-owned credit system designed specifically to provide long-term, low-interest loans on an amortized basis would serve as a pace-setter in solving many of the problems that existed in farm mortgage credit." [7]

At the inception of the System in 1917, the aim appears to have been to provide the farm community—especially the owners of family-size farms—with specialized credit facilities particularly suited to agricultural as contrasted with commercial or industrial requirements. It may be assumed that Congress, in enacting the original legislation, considered the question of taxation of the Federal Land Banks and exempted them in the light of then existing conditions. We doubt, however, that Congress at that time could have foreseen the importance of this exemption—in terms of either competitive advantage or loss of revenue—since taxes at that time did not approach present levels. We find no evidence that Congress, in the years since then, has ever reconsidered this exemption.

But while the tax status has not been altered, there has been considerable broadening of the limits within which the Federal Land Banks can make loans. Take, for example, the maximum loan amount, which in 1916 was set at $10,000. In 1923, the limit was raised to $25,000, though it was required that "preference * * * be given to applications of $10,000 and under." The limit was raised to $50,000 and $100,000 in 1933 and 1949, respectively. In 1955, the maximum was raised to $200,000, and the limit on loans made without prior approval by the Farm Credit Administration was raised from $25,000 to $100,000. In 1959, the ceiling was lifted altogether though FCA approval still had to be obtained on loans of over $100,000.

The result has been a steady expansion of lending activity in the upper ends of the loan range. As Table I shows, 77 per cent of the total amount of Federal Land Bank loans in 1968 (the latest year for which data was available) was for amounts of $20,000 or more. Only 15 per cent was in this category in 1960.

The average size of loan also reveals this trend. From a 1947–49 figure of $4,610, average loan size rose to $21,320—or 362 per cent—in 1965. The average loan size for all lenders, of course, also advanced sharply in this period, under the influence of inflationary trends in the economy generally and of the increasingly larger capital requirements of agriculture, in particular, as its technology advanced and as farm size grew. It is significant, however, that the increase for the Federal Land Banks has been greater than that for all types of lenders and greater than that for any other single group of lenders except insurance companies, which it just matched. Indeed, at least since 1945, the average size of the Federal Land Banks' loan has exceeded that for any other group, except the insurance companies. (See Chart I.)

For example, a Federal Land Bank loan recently made in Alabama was in the amount of $5.4 million.

[7] *Federal Land Bank System and How It Operates,* Farm Credit Administration, Washington, 1965, p. 5. Practically identical passages have appeared in earlier editions of the same document.

Further encouraging the expansion of Federal Land Bank lending activity has been the progressive broadening of the definition of eligible borrowers. In the original legislation, this covered only those engaged in, or shortly to become engaged in, the cultivation of the farm to be mortgaged. In 1933, persons who derived the principal part of their income from farming operations were made eligible. Two years later, "person" was redefined to include corporations engaged in raising livestock. There was, however, the qualification that ". . . no loan * * * be made to a corporation (A) unless all of the stock of the corporation is owned by individuals themselves personally engaged in the raising of livestock on the land to be mortgaged, except in the case where the Land Bank Commissioner permits the loan if at least 75 per centum in value and number of shares of the corporation is owned by individuals personally so engaged and (B) unless the owners of at least 75 per centum assume personal liability for the loan." [8]

In 1961, the restrictions on loans to corporate borrowers were relaxed to state: "* * * but no loan shall be made to a corporation unless the principal part of its income is derived from farming operations and unless owners of stock in the corporation assume personal liability for the loan to the extent required under rules and regulations prescribed by the Farm Credit Administration." [9]

In 1966 and again in 1967, the Federal Land Banks have requested authority to eliminate the statutory loan maximums, the maximum loan which can be made without FCA approval, and the requirements for the assumption of personal liability by stockholders of corporate borrowers.

Greatly liberalizing the scope of Federal Land Bank lending, the Farm Credit Act of 1955 authorized loans for "general agricultural purposes *and other requirements of the owner of the land mortgaged*." (Emphasis supplied.) In the original 1916 statute, it was provided that loans could be made for the following purposes and no other:

1. To purchase land for agricultural purposes.
2. To purchase equipment, fertilizer, and livestock for proper and reasonable operation of the mortgaged farm.
3. To provide buildings and for the improvement of farmland.
4. To liquidate indebtedness existing at the time of the organization of the first Land Bank Association in the county or indebtedness subsequently incurred for the above purposes.

With the 1955 amendment, the purpose of Federal Land Bank operations was, consequently, completely altered. From an organization designed to finance farming operations solely, this newly independent system became one authorized to accept farm assets as security for loans to meet any financial requirement of the landowner.

The Federal Land Banks have undergone a series of organizational changes the most important of which was made in 1953. The Farm Credit Act of that year established the Farm Credit Administration as an independent agency separate from the Department of Agricultural and put the Federal Land Banks on the road to private operation. Since 1947, all federal funds have been out of the System. Thereafter under private ownership and, from 1955, authorized to engage in a broad range of lending business, the Federal Land Banks have moved ahead in the best free enterprise tradition to capture as much business as their unusual competitive advantages make possible.

The steadily growing volume of Federal Land Bank loans—in terms of both number and dollar amount—is shown in Tables II and II–A.

Paralleling this growth has been an expansion in the share of the Federal Land Banks of the total agricultural mortgage loan market—an expansion accomplished, as it must be, largely at the expense of tax-paying lenders. As may be seen in Table II, the percentage of total mortgage lending by Federal Land Banks has grown from 12.3 per cent in 1950 to 24.0 per cent in 1965. In the same period, consequently, the share of individuals in this market has been halved—from nearly 30 per cent to 16 per cent—while farm lending by banks and trust companies has declined from 29 per cent to 20 per cent of the total.

Available data indicate that Federal Land Bank lending, far from being confined to, or even concentrated in, the weaker sector of the farm loan market, is widely distributed among all classes of farmers.

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[8] 12 U.S.C. 1934 ed., Supp. V. 771 (sixth).
[9] 12 U.S.C. 1958 ed., Supp. V. 771 (sixth).

Given the Federal Land Banks' stated aims and given the fact that their tax exemption and their favored position as a borrower permit them to charge an interest rate lower than that generally available from institutional lenders, it might be expected that their lending would be disproportionately heavier in the lower end of the range, or, at most, would be distributed among the various classes of farms in a rough equivalence to their proportions among total farms. But this is not the case. A study by the Federal Reserve Board, based on data from the Census Bureau's 1960 Sample Survey of Agriculture, provides the data shown in Tables III and IV. While 10 percent of all farms had 1960 sales of $20,000 and more, 17 percent of the farm operators with Federal Land Bank loans were in this category. At the other end of the economic classification, 26 percent of all farms had sales of between $50 and $50,000, but only 20 percent of Federal Land Bank borrowers were in this group. (See Table III.)

The average value of land and buildings operated by farmers with major real estate debt in 1960 was about $50,200; land and buildings of Federal Land Bank borrowers had an average value of close to $55,900. (See Table IV.)

Arguments for taxation

Mortgage bankers feel that the Federal Land Banks should be paying taxes. The Federal Land Banks are, in fact, private enterprise organizations just as surely as any mutually owned enterprise. Even were they not, there are precedents in the Federal National Mortgage Association and the Federal Reserve System for a payment in lieu of taxes or a remittance of profits to the Treasury.

A puzzling aspect of this question lies in the fact that their sister institutions, the Production Credit Associations and the Banks for Cooperatives, are taxed; that proposals for rural electric and telephone banks contemplate that they will be taxed following the retirement of federal capital; and that most people seem surprised to learn that the Federal Land Banks are not taxed. To our knowledge the question of the tax status of the Federal Land Banks was not discussed when the legislation was enacted nor has it been raised in subsequent Congressional hearings.

On the other hand, the tax status of other governmental—or quasi-governmental—corporations has been repeatedly discussed. From hearings and legislation there emerges a consensus that such corporations should be taxed—or, as a minimum, that their tax status should be reviewed—when federal funds are repaid. The failure to provide for either taxation or review in the case of the Federal Land Banks is, we believe, a legislative oversight which should be remedied. Moreover, the exemption imposes an unfair competitive burden on the tax-paying enterprises which also serve the agricultural market. We conclude that the circumstances which led Congress to grant exemption to the Federal Land Banks have changed, that their operations have changed, and that their tax-exempt status is now a proper subject for reconsideration.

TABLE I.—PERCENTAGE DISTRIBUTION OF TOTAL AMOUNT OF FEDERAL LAND BANK LOANS, BY SIZE OF LOAN, SELECTED YEARS, 1960–68

[In percent]

Size of loan	1960	1961	1964	1965	1966	1967	1968
$5,000 and lower	21.9	20.4	2.2	1.4	0.9	0.9	0.8
$5,000 to $8,000	23.3	22.3	5.6	4.3	2.6	2.4	2.3
$8,000 to $10,000	11.2	11.8	5.0	3.7	2.4	3.1	2.2
$10,000 to $15,000	18.2	16.7	13.1	10.3	8.6	8.5	8.1
$15,000 to $20,000	10.2	10.6	10.6	9.9	8.8	9.3	9.3
$20,000 and over	15.2	18.2	63.5	70.4	76.7	75.8	77.3
Total, all loans	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: See table IA for greater detail for 1964 and 1965, and a distribution for those years of number of loans by size, which is not available for the earlier years.

Source: Unpublished data of the Farm Credit Administration based on a dependable sample.

TABLE I-A.—PERCENTAGE DISTRIBUTION OF THE NUMBER AND AMOUNT OF FEDERAL LAND BANK LOANS, BY SIZE OF LOAN, 1964-68

Size of loan	Number 1964	Number 1965	Amount 1964	Amount 1965	Number 1966	Number 1967	Number 1968
$5,000 and lower	11.4	8.3	2.2	1.4	6.7	6.8	6.3
$5,000 to $8,000	16.6	15.0	5.6	4.3	10.8	9.6	10.1
$8,000 to $10,000	10.6	9.2	5.0	3.7	7.2	8.8	7.1
$10,000 to $15,000	20.5	18.9	13.1	10.3	18.9	17.7	18.6
$15,000 to $20,000	11.8	13.0	10.6	9.9	13.9	13.7	15.2
$20,000 to $25,000	7.6	9.9	8.8	9.7	9.9	10.3	9.6
$25,000 to $35,000	9.5	10.0	14.4	12.8	12.6	12.1	11.6
$35,000 to $50,000	6.3	6.6	13.5	12.2	9.4	10.0	9.4
$50,000 or more	5.7	9.1	26.8	35.7	10.6	11.0	12.1
Total, all loans	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Unpublished data of Farm Credit Administration based on a dependable sample.

TABLE II —DOLLAR AMOUNT OF FARM MORTGAGES MADE OR RECORDED, BY TYPE OF LENDER SELECTED YEARS 1920-67

Year	Federal land banks	Life insurance companies	Banks and trust companies	Individuals	Miscellaneous lenders	Total, all lenders
Dollar amount:						
1920	$67,000	$386 800	$663 200	$2 142 800	$366,200	$3,625,800
1930	47,100	173,700	355,200	618,200	170,600	1,364,600
1940	63,900	145,600	219,800	225,600	117,400	772,500
1950	203,100	348,000	471,600	491,800	140,800	1,655,900
1955	482,700	507,000	582,000	565,900	264,200	2,401,900
1960	520,213	413,337	541,022	612,481	482,682	2,569,735
1965	1,237,876	964,080	1,036,524	811,594	1,108,046	5,158,120
1966	1,344,610	909,341	1,055,992	934,882	1,195,341	5,440,166
1967	1,266,533	695,625	1,036,109	860,318	1,216,460	5,075,045
Percentage distribution:						
1920	1.9	10.7	18.3	59.1	10.1	100
1930	3.5	12.7	26.0	45.3	12.5	100
1940	8.3	18.8	28.5	29.2	15.2	100
1950	12.3	21.0	28.5	29.7	8.5	100
1955	20.1	21.1	24.2	23.6	11.0	100
1960	20.2	16.1	21.1	23.8	18.8	100
1965	24.0	18.7	20.1	15.7	21.5	100
1966	24.7	16.7	19.4	17.2	22.0	100
1967	25.0	13.7	20.4	17.0	24.0	100

Source: Farm Credit Administration, Research and Information Division.

TABLE II-A.—NUMBER OF FARM MORTGAGES MADE OR RECORDED, BY TYPE OF LENDER, SELECTED YEARS, 1940-6/

Year	Federal land banks	Life insurance companies	Banks and trust companies	Individuals	Miscellaneous lenders	Total, all lenders
1940	26,258	25,285	110,083	135,037	28,674	325,337
1950	42,820	35,649	126,012	115,805	32,069	352,355
1955	60,490	34,082	114,048	86,586	41,825	337,030
1960	43,090	18,476	85,141	62,176	57,456	266,339
1965	58,050	24,011	92,895	47,453	82,378	304,787
1966	53,643	19,062	84,164	46,168	74,870	277,907
1967	48,189	13,485	79,116	40,446	70,480	251,716
PRECENTAGE DISTRIBUTION						
1940	8.1	7.7	33.8	41.5	8.8	100
1950	12.2	10.1	35.8	32.9	9.1	100
1955	17.9	10.1	33.8	25.7	12.4	100
1960	16.2	6.9	32.0	23.3	21.5	100
1965	19.0	7.9	30.5	15.6	27.0	100
1966	19.3	6.9	30.3	16.6	26.9	100
1967	19.1	5.4	31.4	16.1	28.0	100

Source: Farm Credit Administration, Research and Information Division.

TABLE III.—ALL FARM OPERATORS, AND FARM OPERATORS WITH FEDERAL LAND BANK MAJOR REAL ESTATE DEBT, BY ECONOMIC CLASS OF FARM, 1960

Economic class of farm	Number (in thousands)	Percent of all farms	Percent of commercial farms
All farm operators:			
Total, all farms	3,247	100.0	
Noncommercial farms [1]	986	30.4	
Commercial farms, total	2,261	69.6	100.0
Class I	105	3.2	4.6
Class II	228	7.0	10.1
Class III	490	15.1	21.7
Class IV	590	18.2	26.1
Class V	541	16.7	23.9
Class VI	307	9.5	13.6
Operators with Federal land bank loans:			
Total, all farms	254	100.0	
Noncommercial farms [1]	48	18.9	
Commercial farms, total	206	81.1	100.0
Classes I and II	43	16.9	20.9
Classes III and IV	113	44.5	54.9
Classes V and VI	50	19.7	24.2

[1] Noncommercial farms are in general those with sales of $2,499 or less.

Note: Economic class of farm by value of farm products sold: I—$40,000 and over; II—$20,000 to $39,999; III—$10,000 to $19,999; IV—$5,000 to $9,999; V—$2,500 to $4,999; VI—$50 to $2,499.

Source: Farm debt, data from the 1960 Sample Survey of Agriculture; Board of Governors of the Federal Reserve System, 1964. Table 1, p. 3; table 31, p. 119.

TABLE IV.—AVERAGE VALUE OF LAND AND BUILDINGS OPERATED, BY ECONOMIC CLASS OF FARM, FOR SELECTED OPERATORS, 1960

Economic class of farm	All operators with major real estate debt	Federal land bank borrowers
Commercial farms, total	$61,796	$64,166
Classes I and II	163,049	155,629
Classes III and IV	45,156	47,848
Classes V and VI	19,378	22,193
Noncommercial farms	15,961	20,250
All farms	50,187	55,866

Note: See table III for definitions of economic classes of farms.

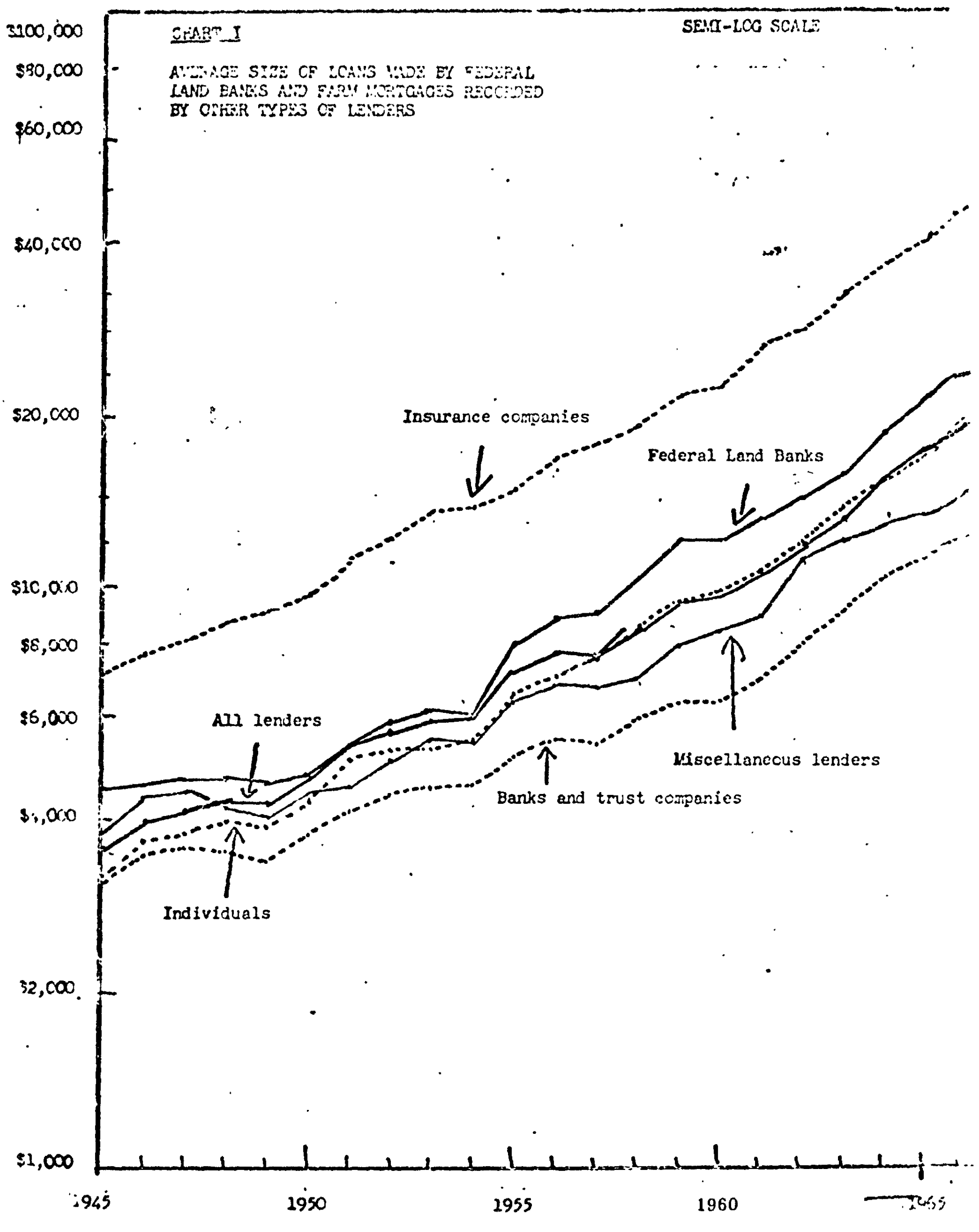
Sources: Farm Debt (Federal Reserve Board report), 1960, table 1, p. 7; table 31, p. 119. Some weighted averages constructed by MTB.

TABLE IV-A.—NUMBER OF FARMS, BY VALUE OF PRODUCTS SOLD, 1950, 1959, AND 1964

Type of farm	1950		1959		1964	
	Number	Percent	Number	Percent	Number	Percent
All farms	5,379,250	100.0	3,708,022	100.0	3,157,864	100.0
Commercial farms: Total	3,706,412	68.9	2,416,045	65.2	2,165,727	68.6
Sales of—						
$25,000 or more	103,231	1.9	260,121	7.0	336,826	10.7
$10,000 to $24,999	381,151	7.1	535,552	14.4	532,079	16.8
$5,000 to $9,999	721,211	13.4	653,533	17.6	504,625	16.0
$2,500 to $4,999	882,302	16.4	617,819	16.7	443,928	14.1
$2,499 or under	1,618,417	30.1	349,020	9.4	348,269	11.0
Other farms	1,672,838	31.1	1,291,977	34.8	992,137	31.4

Note: The categories used by the census of 1950 were somewhat different from those for the later years; combinations were made to put the data on a common basis. For definitions of various types of farms, see table III.

Source: Department of Commerce, Bureau of the Census; U.S. Census of Agriculture, 1950, 1959, 1964, vols. I and II.



[H.R. 9242, 91st Cong., first sess.]

A BILL To amend section 504 of the Internal Revenue Code of 1954, relating to the tax exemption of certain organizations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (*a*) section 504 of the Internal Revenue Code of 1954 (relating to denial of exemption of certain organizations) is amended by redesignating subsection (*b*) as subsection (*c*) and by inserting after subsection (a) the following new subsection:

"(b) FEDERAL LAND BANKS AND FEDERAL LAND BANK ASSOCIATION.—Notwithstanding the provisions of any other law, no Federal land bank or Federal land bank association shall be exempt from the taxes imposed by this subtitle on corporations."

(b) The amendments made by subsection (a) shall be applicable with respect to taxable years beginning after the date of enactment of this Act.

The CHAIGMAN. The next witness will be Mr. Harry Newman, Jr., president of the International Council of Shopping Centers. Mr. Newman, will you proceed?

STATEMENT OF HARRY NEWMAN, JR., PRESIDENT, INTERNATIONAL COUNCIL OF SHOPPING CENTERS; ACCOMPANIED BY ALBERT SUSSMAN, EXECUTIVE VICE PRESIDENT; AND ARTHUR GOULD, TAX COUNSEL

Mr. NEWMAN. Mr. Chairman, may I first introduce Mr. Albert Sussman, who is the executive vice president of the International Council of Shopping Centers, on my left; and Mr. Arthur Gould, who is our tax counsel, on my right.

My name is Harry Newman, Jr., and I am the president of the International Council of Shopping Centers.

I am here not only to represent our 3,200 members who are engaged in the development and operation of shopping centers in all 50 States but also to underline some of the grave consequences of the proposed tax reform act.

In its present form we believe—

The bill will put a number of independent developers out of business.

It will prevent thousands of potential entrepreneurs from getting into businesses of their own and seriously discourage expansion of existing small merchants dealing in retail goods and services.

It will put most new centers, esperially small ones, into the deep freeze.

It will drive the large subsantial developers into the arms of the financial giants and accelerate concentration of ownership in their hands.

It will take the private investor and his equity capital out of the market.

Just three provisions of the act will insure these undesirable results:

The change in accelerated depreciation provisions.

The change in the recapture provisions at the time a center is sold.

The imposition of a limitation on deductions of interest.

Before discussing these provisions in more detail, I would like to put their impact into proper perspective, because it is even greater than the House of Representatives and many of our own members initially recognized.

Before World War II, the shopping center as we know it did not exist. Today there are almost 11,000 in existence in the United States—90 percent of them are small—pumping almost $100 billion through their checkstands every year, employing 4½ million people, representing an investment, excluding land, of $54 billon.

These are impressive vital statistics for a latecomer to the real estate field and to the economy, but there is more.

By 1980, there will be more than 22,000 centers, employing 18,440,000 people, reflecting an additional investment of $180 billion in improvements, and producing $200 billion in annual sales.

When we appreciate the present magnitude and the potential for growth of this industry—incidentally, without one single Government grant or subsidy—then we can see more clearly and in proper perspective how serious these consequences can be.

By eliminating accelerated depreciation, especially for the second owner of a shopping center, and by requiring total recapture of excess over straight-line depreciation, the bill will make it uneconomic for the developer to sell his center after the full holding period and even less attractive for a prospective investor to buy it.

Add to these two disincentives the limitation on interest deduction, which was aimed at the passive investor but can now be mistakenly applied to the active developer who is in the business of building, owning, and operating centers, not just investing in them. Then put in the final ingredient, the Treasury's recommendation that all expenses during construction be included as limited tax preference items and be taxed at a time when there is no income. Mix all these ingredients in an existing potful of problems like interest, up 89 percent since 1965; construction costs, up 26.9 percent; property taxes, 28.5 percent; and land cost, 20 percent; and you have a paralyzing, poisonous brew.

What antidote are we going to administer? Higher rents and more inflation?

When you consider that rents have gone up only 12 percent since 1965 compared to the substantially higher increases in all costs, this is obviously not going to solve the problem.

What is left?

Those of us who have been developing or are qualified to develop regional centers have a way out. We can bring in giant financial institutions as partners. Let me read you a paragraph from a letter I received from our then private joint venture equity partner 1 week ago:

> Since we do not know when the tax picture will become clear or even if real estate developing will be an attractive investment vehicle for our clients, I would encourage you to find another equity partner.

So we now are working with a major financial institution. This is one of many such examples, but note that only large projects qualify. It is as easy for an insurance company to make a $20 million loan on a regional center as an $800,000 loan for a neighborhood center, and remember, those small centers represent 90 percent of all centers. It is also easier to buy a development company than to start your own—and insurance company holding companies are in the process of doing both with increasing frequency. All this adds up to one economically undesirable total—economic concentration.

What this all boils down to is this. The shopping center industry can create 14 million jobs. It can provide business opportunities for small merchants and service businesses. It can provide sources for private investment capital. It can produce premium tax revenue for local communities.

It can revitalize the retail sections of urban core areas. But not without important risks.

Although completed shopping centers have an outstanding performance record—almost failure-free—and are therefore regarded as low risks by mortgage lenders, there are in fact many risks and they occur during the development period. Like the oil industry, there are lots of dry roles.

I am here to ask you to retain the incentives for these positive contributions to our economic welfare. Do not take them away and jeopardize an entire industry to correct a few atrocity cases of tax inequity and abuse.

There is a basic social and philosophical principle at stake in this bill. America and its economy have been built by risk-takers, the entrepreneurs. America has motivated men to take these risks by offering them incentives.

Our shopping center industry also has been built by just such risks, skills, and rewards; at a time when it is trying to weather the economic storms for survival, we genuinely hope that you will recognize the industry's contribution to our society and not deprive it of its most dynamic driving force.

In conclusion, let me emphasize that we favor a minimum tax for every taxpayer. H.R. 13270, however, excluded the oil industry from its provisions. The Treasury now recommends excluding interest on municipal and State bonds along with the appreciated value of assets contributed to charity. This would be manifestly unfair to the real estate industry and to the so-called gentleman farmer. In our opinion, there should be a minimum tax and everyone should pay it.

I appreciate this opportunity to present our viewpoint to you and respectfully hope that our comments may help you in your deliberations.

Thank you very much.

The CHAIRMAN. Thank you very much, sir.

(Mr. Newman's prepared statement follows:)

STATEMENT OF HARRY NEWMAN, JR., PRESIDENT, INTERNATIONAL COUNCIL OF SHOPPING CENTERS, NEW YORK, N.Y.

SUMMARY

The International Council of Shopping Centers is a trade organization of more than 3,200 members engaged in the development and operation of shopping centers and in their design, leasing, construction and financing. Many chain and independent retail merchants now operating stores in shopping centers are also members of the council.

Our developer members have built and are operating more than 9,000 shopping centers containg more than 195,000 retail stores in the United States alone. As an industry, shopping centers represent a total investment of more than $54 billion and supply employment for more than 4,500,000 persons.

Before discussing the effect of the Tax Reform Bill on our industry and our view of the consequences for the economy, I would like to express our wholehearted support for the basic aim of the legislation before this committee, namely, the elimination of tax inequities and the minimum-tax approach to achieving it.

The main purpose of our testimony here, then, is to describe to you the grave implications of those provisions in the proposed Act that affect our specialized segment of the real estate industry. In its present form, we believe that the Tax Reform Act of 1969 will have these consequences:

1. It will accelerate the existing trend towards economic concentration of shopping center ownership in the hands of a relatively few large financial institutions and big corporations.

2. It will seriously curtail the construction of smaller centers, which are an essential ingredient in the mass housing programs planned for the next decade. Shopping center developers will not be able to build these centers because they will have no venture capital sources to replace both private investors and those funds normally generated through the sale of their existing centers.

3. This curtailment in turn fill eliminate a sizeable number of the almost 14 million new low-skill jobs which the shopping center industry would otherwise create by 1980.

4. The development of fewer new centers means depriving expanding and/or new municipalities and other local government bodies of desperately needed revenues for their operating expenses from property and sales taxes.

5. Expansion of independent merchants, so-called mom-an-pop operations, local chains and other dynamic tenants will be seriously curtailed and in many cases completely halted.

6. The higher yields needed to attract venture capital as compensation for the loss of present tax advantages will lead to increases in already spiraling rents and thus place further inflationary pressures on the prices of consumer goods and services.

7. In order to survive, independent developers will be virtually compelled to merge with large corporations or be taken over by them in order to obtain the high-risk venture capital essential to develop shopping centers.

8. By withdrawing tax inducements from private redevelopers, while preserving subsidies of billions of dollars from HUD, the Act will seriously discourage urban core retail redevelopments, which, in our opinion, deserve the highest priority in both the private and government sectors.

9. It will create serious difficulties for black business and community groups that are now striving to develop shopping centers in the inner-city core areas of at least 50 major cities.

10. Insofar as the real estate industry is concerned, Section 221 was presumably aimed at the passive high-income investor. In fact under this section's definitions and exclusions, virtually every shopping center owner who is actively operating a center will be subject to the limit on interest deductions because practically every shopping center in the country and its leases qualify as "net leases." This, coupled with the Treasury's suggestion that certain business deductions during construction be singled out for Limited Tax Preference treatment, may well drive most individual investors and developers out of a business already made economically marginal by a combination of tight money, record interest rates and skyrocketing construction costs, property taxes and land prices.

We therefore, recommend that present real estate tax inducements remain in effect, but that an equitable minimum tax law be enacted to correct the few but glaring inquities and abuses of the past.

STATEMENT

Mr. Chairman and members of the Committee, my name is Harry Newman, Jr. I am president of the International Council of Shopping Centers, a trade organization of more than 3,200 members engaged in the development and operation of shopping centers and in their design, leasing, construction and financing. Many chain and independent retail merchants now operating stores in shopping centers are also members of the Council.

Our developer members have built and are operating more than 9,000 shopping centers containing more than 105,000 retail stores in the United States alone. As an industry, shopping centers represent a total investment of more than $54 billion and supply employment for more than 4,500,000 persons.

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We, therefore, recommend that present real estate tax inducements remain in effect, but that an equitable minimum tax law be enacted to correct the few but glaring inequities and abuses of the past.

WHAT IS THE DEVELOPMENT BUSINESS?

Let me explain something about the nature of the development business before elaborating on the reasons for the ten points of what may seem at first glance to be the shopping center industry's True Bill against the Tax Reform Act.

Shopping centers have enjoyed a remarkable record of successful operation and foreclosures are extremely rare. Because of this performance and the high percentage of so-called AAA-credit, or major chain tenants, in each shopping center, insurance companies and other lenders have come to regard shopping centers as low-risk or no-risk investments.

Once the center is finished, this is an accurate assessment. However, during the development stages, the developer alone, or in conjunction with his equity investor, is exposed to a variety of risks which can jeopardize his investment and, at worst, send him into bankruptcy. These risks and unexpected costs occur from the site selection phase to the point in time after the center is completed and the developer is ready to collect his long-term mortgage funds from the permanent lender. They range from delays caused by frozen ground, snow and rain to strikes, unexpected site conditions, zoning and title problems. They range from mistakes by the architects and engineers to delays because of tenant improvements or tenant bankruptcies. They range from uncontrollable cost increases in construction, financing charges and real estate taxes to breakdowns in deliveries of essential supplies and materials.

There are other hidden risks. For every center that is developed, there are at least 12 that never see the light of day, but may have reached the zoning, layout, or at least the acquisition-negotiation stage. Although it is an extreme example, my company recently investigated 73 individual sites before we found a suitable location for a chain department store. Each of these attempts at finding a shopping center location resulted in relatively substantial expenditures to say nothing of the time involved.

Once the developer has found the site, he must tie up the land on an option or by some other means, so that he has enough time to determine the major tenant's interest in the site. In order to stimulate interest on the part of a supermarket if it is a neighborhood center location, or a department store if it is a regional center site, he must have layouts and economic studies prepared. He must also work out the financial projections for the center to determine the rentals he must get. This involves a high degree of guessing what construction costs and interest rates will be in six monhs, a year, or two years depending on the size and gestation period for the proposed center.

Assuming he gets the tenant's approval of the site, he must then lease enough of the remaining stores to chain stores or tenants with multi-million dollar net worths to enable him to secure a mortgage loan commitment from an insurance company or other financial institution. At this point the developer normally must purchase the land and this requires substantial cash, usually more than he has available because of his investments in other centers. This explains the importance of the equity investor to the developer's continuing activity.

Once the investor has been brought into the development picture, the developer then has to negotiate his contract with the architect and engineers, negotiate a contract with a general contractor, and complete his leasing negotiations for the other vacant stores. He must coordinate the activities and responsibilities of the architect, contractor and tenants, while making arrangements for a construction loan based on the commitment for his permanent mortgage loan. He must then complete the center according to tenants' plans, move them in, and set up the management, promotion and maintenance of the completed center. Then he can at last "close" the permanent mortgage loan, thhe proceeds of which are used to pay off the construction loan. The development process cannot be described adequately in such brief terms, but hopefully we have conveyed to you some idea of the complexities, uncertainties and risks which characterize the business.

ECONOMIC CONCENTRATION

More than 90 percent of the shopping centers in this country are developed by individuals and small independent corporations or partnerships, who provide the skills, manpower and part of the equity investment required for the shopping centers they build. They are not able to develop shopping centers without entering into partnerships with one or more investors in each center. They need these partners to help them put up the equity investment of 10 to 25 percent normally required for each venture.

These equity investments range from $50,000 to several million dollars each, depending on the size of the center, the cost of land and buildings, and the amount of mortgage financing they can obtain. Very few developers who are actively building new centers can afford (or have the funds necessary) to finance their own centers without partners. Because of the high risks involved and the relatively large amounts of venture capital needed, the investor partners who join the developers in their projects are almost always private parties seeking commensurately high returns on their investment. If they are denied the inducement of tax savings, they will have little reason to invest their money in these projects. They will put their money in other types of investment, and developers will have difficulty getting shopping centers built in the future.

To remain in business, developers will have to find other sources of equity funds. They will have to turn to large corporate investors, to public financing and to institutional investors.

What concerns me and I think should concern your Committee is that the Tax Reform Act will make it difficult for the independent shopping center entrepreneur to survive and will result in the increasing domination of our industry by large financial and/or corporate interests.

The Committee should be aware that since the 1966 monetary crisis and credit crunch, the shopping center industry has been plagued by a shortage of mortgage funds, record-high interest rates, accelerating construction costs, rising property taxes and skyrocketing land prices. These inflationary pressures are particularly serious for a high-leverage business like shopping center development where the loan usually represents 75 percent or more of the total project costs. Rents have not risen at a comparable pace and profite margins consequently have been eroded to a point where tax deductions available under the present laws are playing an increasingly vital part in the economics of shopping center development. I refer you to Appendix B, attached to this report, which shows that from 1965 to 1969, land prices, property taxes, construction costs and prime interest rates rose 20 to 88 percent. During the same period, rental income increased only 12 percent.

Even before the Tax Reform Act was conceived, high interest rates and other inflationary pressures started to reshape the shopping center industry. Major supermarket chains, discount stores and traditional department stores began to develop their own free-standing branches, tending to eliminate the independent developer. In addition, lending institutions began to insist on a piece of the equity and demanded a share of minimum and/or overage rents as a prerequisite for a mortgage loan. As a result of these and other factors, the position of the independent developer has been increasingly threatened.

The Tax Reform Act will accelerate the trend towards the concentration of ownership, operating control of the industry, and a virtual monopoly of most new developments in the hands of big corporations and big institutional investors. I am not suggesting that they even want this control, but under the changed dynamics of the industry they will be the only ones who can afford it.

FEWER SMALL CENTERS

Since their inception, shopping centers have attracted hundreds of new business enterprises and opened opportunities for hundreds of individuals and groups to become engaged in development as independent entrepreneurs.

This has, in fact, been the history of my own company. I am before you now to fight for the life of my company and hundreds of others like mine, and to retain our ability to continue as independent enterpreneurs in a competitive, viable economy.

Let us examine for a moment what will happen to neighborhood centers if the private investor and independent developer are eliminated as economic factors.

In order to weigh the importance of the small center in the consumer economy, keep in mind that out of 10,820 shopping centers operating at the end of 1968, 9,300 (almost 90 per cent) were neighborhood or community centers.

Because size is equated with financial return, institutional developers are primarily interested in developing and owning regional centers where the retail action is concentrated in the hands of the large retailers and national retail chains. Smaller centers do not have the "economic glamor" and are too small to attract the financial institution as an investor, joint venturer or developer.

With the private investor removed from the scene, who is going to develop the literally thousands of neighborhood centers needed to service the 2,300,000 new houses scheduled for construction every year for the next decade? Competition will be curtailed or eliminated. Where this happens, the Act will create captive-market conditions which encourage price exploitation and which have been a significant factor contributing to minority unrest and riots in slum areas.

LOSS OF JOBS

The retailing industry traditionally has provided substantial numbers of jobs for people who rank at the lowest economic level in the community. It is questionable if the economy will be able to absorb those individuals who may be displaced from retailing operations, since many of them have very limited employment skills.

Based on the estimate that 2½ new full-time jobs are created for every 1,000 square feet of gross leasable area, almost 14 million jobs can be created by the development of shopping centers in the next 11 years. The Tax Reform Act in its present form will jeopardize a substantial number of those jobs, mostly unskilled, the most difficult to place in other sections of the economy.

LESS TAXES FOR LOCAL COMMUNITIES

Those shopping centers which have been built this year or will be completed by the end of 1969 will contribute $25 million in property taxes to the communities in which they are located.

This is especially welcome because it is premium revenue. Shopping centers, at their expense, provide many of the services normally required from the local municipality, for example, parking areas, sidewalks, malls, landscaping, lighting, security, trash removal, parking lot maintenance and repair. Developers also frequently dedicate land for streets and put in the streets, curbs, gutters and sometimes the sewage system, fire hydrants and the water distribution system.

By 1980, in order to service the projected 30 million growth in population, the number of shopping centers will double, adding viable local tax revenue to local municipalities and communities.

The Tax Reform Act, if passed in its present form, could drastically reduce the number of new centers to be built and deprive new, expanding and redevelopment communities of critically needed tax revenues.

SMALL RETAILERS JEOPARDIZED

The private investor's willingness to risk his money in shopping center development has been largely responsible for helping "mom-and-pop" stores convert to franchise operations. Franchise operations have had a phenomenal growth record. They range from fried chicken and roast beef sandwiches to auto brakes, mufflers and bridal wear. The investor's dollar has also made economically viable the smaller centers with their inevitable complement of barber, beauty, cleaner-type of service shops.

Shopping centers create small retail businesses. If shopping center development is curtailed, there will perforce be fewer opportunities for small retailers to go into business and to expand their operations.

INCREASED INFLATIONARY EFFECTS

At the present time, private investors like lawyers, doctors, small businessmen, etc., who constitute the majority of shopping center equity investors, are willing to risk their savings for an 8 or 9 per cent return coupled with tax advantages which enable them to offset some of their ordinary income.

Remove these inducements, and how marketable a commodity does the shopping center developer have?

Apart from the extensive risks involved during the developmental stage, shopping centers have one other major drawback from an investment viewpoint—lack of liquidity. Unlike shares on the stockmarket, a shopping center with its multiple tenancies and other complexities, and special requirements, not the least of which is a large cash investment, is difficult to sell. By removing the accelerated depreciation provision and other tax advantages for second owners, the new law will make centers virtually impossible to sell.

It might seem that there is a simple solution to this dilemma—increase the yield to compensate for the loss of tax advantages.

The only way to achieve this is to raise rents even further. We have already witnessed the lag in rental increases behind the spiraling costs of development.

In our opinion, rents cannot be increased enough to provide the additional yield which investors in this non-liquid, high-risk field might reasonably demand, without jeopardizing the survival of the retail merchant and placing irresistible pressure on the retailer to try to pass on his increased occupancy cost to the consumer in the form of higher prices.

Neither Congress nor the shopping center industry wants to penalize the consumer and speed inflation in order to correct a few inequities in our tax structure.

MERGE OR SELL OUT FOR SURVIVAL

As cited earlier, the elimination of the private investor and the inability of developers to attract financial institutions as investor-partners will hamstring most independent development activities. In addition, because developers will be unable to sell their centers under the proposed law, new projects will dry up or atrophy. Unable to recoup their investments on existing centers and facing high costs of land and money, developers will not be able to undertake new projects at the very time that the demands for new retailing facilities and their own operational needs dictate that these projects be initiated.

The ultimate effect of the provisions in their present form will be to force shopping center developers to incorporate, to merge with large corporations, or to go out of business.

This trend has already become apparent as a result of prevailing economic conditions. Suppliers of building materials, diversifying corporate giants and insurance companies in the past two years have bought existing development firms with experience and expertise, who were being pinched by under-financing and the critical money shortage.

H.R. 13270 contains a number of provisions, namely Sections 411, 412, 413 and 414, specifically designed to inhibit the trend towards economic concentration which has occurred because of the recent waves of corporate mergers and acquisitions. In fact, the House Ways and Means Committee report notes that "this trend in merger activity raises numerous significant questions, such as its effect on the competitive climate in the United States, and the overall effect of this activity on the U.S. economy." The House considered this trend towards economic concentration to be so disturbing that it deemed it advisable to utilize the tax laws to impose a number of restraints upon such corporate merger activities. Nevertheless, in the very same bill, the House has approved a number of changes with respect to the tax treatment available for real estate activities, which inevitably will lead to economic concentration within the shopping center industry.

The evil of economic concentration within any industry is obvious. If the ownership of shopping centers is concentrated in the hands of a relatively small group of large landlords, the bargaining position of any prospective tenant, large or small, will be seriously compromised.

To see how the proposed legislation, coupled with present economic conditions, will encourage mergers and acquisitions, one need only look at the tract housing industry, where the small independent developer has become an anachronism and virtually disappeared from the scene.

SETBACK FOR URBAN REDEVELOPMENT

Most of the successful urban redevelopment projects completed to date have been the work of private entrepreneurs. Many shopping centers are planned as part of the redevelopment of core areas, but developers have learned that this type of project involves at least twice as much time and documentation as conventional projects.

My own organization's experience is typical. We are general partners in a redevelopment project in the downtown area of Richmond, California, which will embrace 30 city blocks and in its completed form consist of 1,300,000 square feet of retail space. We have spent many thousands of dollars on legal fees, economic studies, plans, renderings and brochures for prospective tenants (See photographs). However, because the proposed project is now ringed by a predominantly black, low-income slum area, we are encountering difficulty and delays in persuading major department stores that the entire environment will be dramatically altered by the proposed development, and that the 825,000 potential customers in the primary and secondary trading areas will insure as profitable an operation as a white suburban community.

As developers we wanted to undertake this project because of the social benefits to the community as well as the prospect of a sound return on our investment of time and money.

HUD's subsidy of the land and the city's willingness to provide a $10 million parking structure have made the project economically viable and have given us a substantial inducement to proceed. Relying on the tax treatment permitted under the present law, we and our partners decided to tackle the special problems involved in a redevelopment project of this magnitude.

It seems paradoxical that with one hand the government could create inducements for developers to tackle such assignments and with the other remove equally significant inducements.

If H.R. 13270 is passed, we would be forced to re-examine our potential return on investment in relation to the additional time and risks this project would entail. Our resopnse, I believe, is typical of others involved in urban retail redevelopment projects.

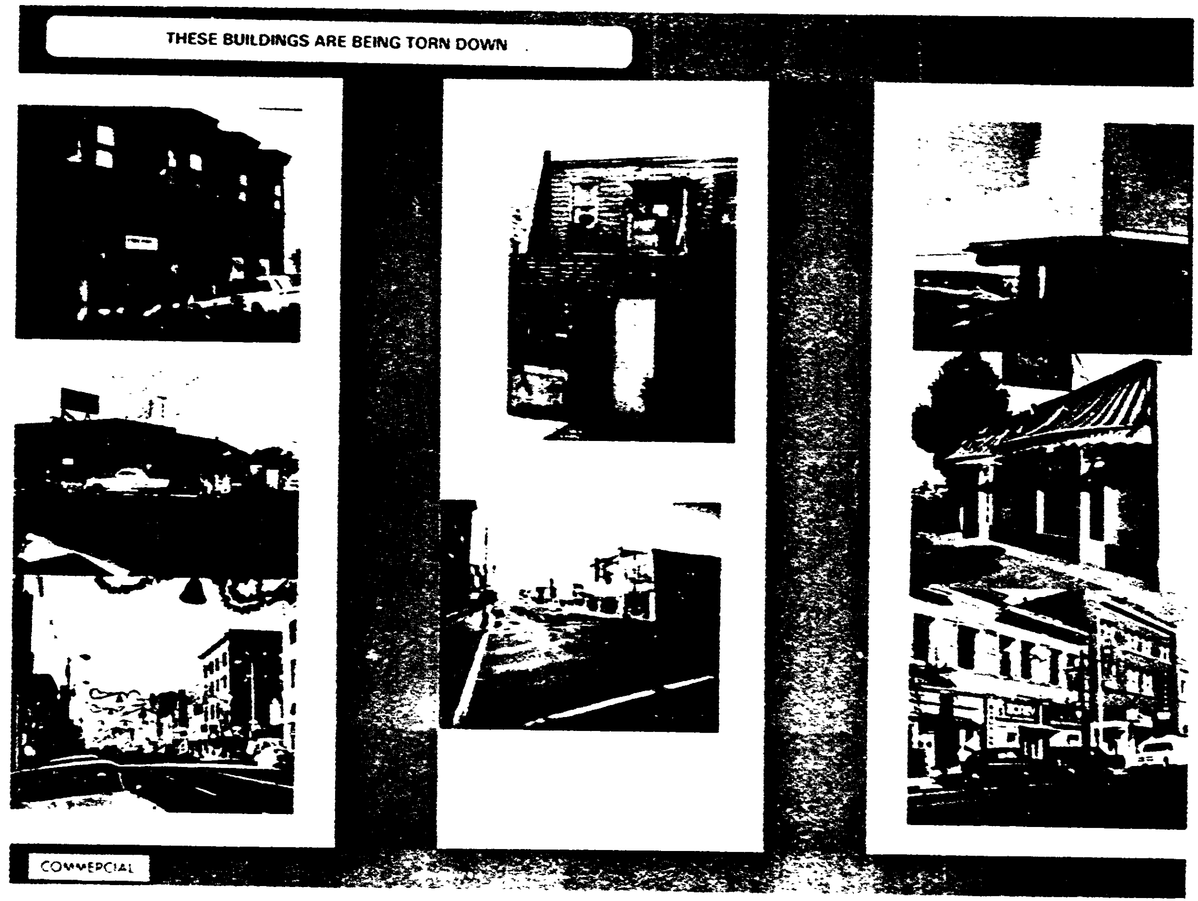
BLACK SHOPPING CENTER DEVELOPMENT

The International Council of Shopping Centers has played an active role in helping to train black businessmen and community groups who are now attempting to develop shopping centers in at least 50 major cities. These centers will help to redevelop slum areas. They will help set up new businesses. They will create jobs for members of minority groups.

These centers need every possible financial assistance to become economically self-sufficient. Unless they are able to avail themselves of accelerated depreciation and other tax reductions, they will have added obstacles to overcome.

NET LEASE HAS WRONG TARGET

In the shopping center industry, Section 221 of H.R. 13270 will apparently apply not only to the passive investor, but also to the active developer. Under the definitions in the law, most shopping centers and their leases would qualify as "net leases." The allowable operating expenses (as defined) rarely exceed 15 per cent of rental income in virtually all shopping centers and/or shopping center leases.


THESE BUILDINGS ARE BEING TORN DOWN
COMMERCIAL

AND THIS IS THE FUTURE RICHMOND...COMING SOON

We cannot believe that the House intended the entire shopping center industry to come within the scope of this provision.

Section 221 will effectively rule out real estate for all investors except those with substantial amounts of liquid funds but seeking a much higher return on investment than is now available.

Shopping center developers are in the "trade" and/or "business" of developing and operating shopping centers. They are not passive investors. Yet the Limitation on the Deduction of Interest applies to developers as if they were passive investors and rules them out of the "trade or business." Section 221 creates other inequities as well, which were pointed out by the Treasury when it recommended that Section 221 be deleted. We strongly support their stand.

CONCLUSION

The shopping center industry is already in a precarious position. Rising interest rates appear to be only a nuisance to large corporations. For shopping center developers, they are a disaster. A 1 per cent increase in the mortgage loan rate, for example, reduced the yield on invested capital in one of our recent centers by 75 per cent. Profit margins are being eroded further by runaway construction costs, land prices and rising property taxes unrelated to income.

The most recent Treasury proposal to treat interest, taxes and rents paid by a developer during the period of construction as Limited Tax Preference items would impose yet another burden upon the developer.

This proposal together with the serious immediate repercussions and long-range consequences of those provisions of the Tax Reform Act affecting our industry have a cumulative effect. They may represent the breaking point for the shopping center industry. Although the economy might conceivably survive its demise, such is obviously not the purpose of either the House or the Senate.

The serious implications of such an eventuality in the form of lost jobs, inadequate retail facilities, inflationary pressures, curtailment of tax revenue for local government bodies, retarded urban redevelopment, and perhaps most serious, accelerated economic concentration cannot be overlooked or underemphasized.

I wish to emphasize that we favor a minimum tax for every taxpayer. H.R. 13270, however, excluded the oil industry from its provisions. The Treasury now recommends excluding interest on municipal and state bonds along with the appreciated value of assets contributed to charity. This would be manifestly unfair to the real estate industry and to the so-called gentleman farmer. In our opinion, there should be a minimum tax and everyone should pay it.

Finally, there is a basic social and philosophical principle at stake in this bill. America and its economy have been built by risk-takers, the entrepreneurs. America has motivated men to take these risks by offering them incentives.

Our shopping center industry also has been built by risks and skills activated by incentives. At a time when it is trying to weather the economic storms for survival, we genuinely hope that you will recognize the industry's contribution to our society and not deprive it of its most crucial driving force.

I appreciate this opportunity to present our viewpoint to you and respectfully hope that our observations may help you in your deliberations.

APPENDIX A—SHOPPING CENTER INDUSTRY STATISTICS

In the aggregate, the shopping center industry in the United States represents an investment of approximately $33.4 billion in construction alone. An additional $21 billion is estimated to have been expended to equip the retail stores in the nation's shopping centers. They currently supply employment for an estimated 4,500,000 persons.

In the next dozen years, 1969 through 1980, shopping center construction (if permitted to occur by the tax law, and by the cost and availability of money) and equipment installed in shopping center stores would require the expenditure of an estimated $180 billion (in 1968 dollars).* This expenditure is exclusive of money spent for land.

By 1980, shopping centers, if built according to our projections, will account for the annual employment of some 18,440,000 persons. Although managers and department heads are highly skilled persons, a very large proportion of retail workers are relatively unskilled and, in a large number of cases, are marginal

*Shopping center construction would make up some 90 per cent of total retail store construction.

employees. The unskilled and marginal employees, many of them part-timers, would in many cases find it difficult to obtain other employment and would have to be supported by the public treasury. Many are employed at or close to minimum wages, adjusted for urban or non-urban factors.

Shopping centers in the United States currently account for 42 per cent of all retail trade, exclusive of automobiles, service stations, hay, grain, feed, fuel, ice and lumber. By 1980, their share of the retail market should approximate 50 per cent.

For 1968, retail sales in shopping centers in the United States were some $87.8 billion dollars. They are projected at $94.5 billion for 1969.

The overwhelming majority of shopping centers in the United States are small projects. Centers of less than 100,000 square feet number 6,500, and centers running from 101,000 square feet to 200,000 square feet number 2,800. To round out the picture, centers from 201,000 square feet to 400,000 square feet number 1,000, and centers larger than 401,000 square feet number 520, as of the end of 1968.

APPENDIX B—A COMPARISON OF INCREASES IN KEY ITEMS OF SHOPPING CENTER COSTS, 1965-69

Item	1965	1967	1969	Increment 1965-69 (percent)
Prime interest rates [1]	4.5	5.6	8.5	88.9
Construction cost index [2]	117.2	130.2	148.7	26.9
Property tax index [3]	128.4	148.1	165.0	28.5
Land price index [4]	100	110	120	20.0
Shopping center rents [5]	$1.83	$1.94	$2.05	12.0

[1] U.S. Housing Foundation, August 1969.
[2] Construction cost index by E. H. Boeckh, commercial and industrial buildings, as reported in Survey of Current Business, U.S. Department of Commerce (various issues).
[3] Price deflator index for retail component of GNP, as reported in Survey of Current Business, U.S. Department of Commerce (national income issue).
[4] Commercial land price index (estimate by ICSC based on 5 percent land cost appreciation per year).
[5] Average rents in regional shopping centers per square foot of gross leasable area—"Dollars and Cents of Shopping Centers," published by Urban Land Institute.

The CHAIRMAN. Now the next witness will be Mr. Philip N. Brownstein, Council of Housing Producers.

Will you proceed, sir?

STATEMENT OF PHILIP N. BROWNSTEIN, COUNSEL, COUNCIL OF HOUSING PRODUCERS

Mr. BROWNSTEIN. Thank you, Mr. Chairman, and members of the committee. I am Philip Brownstein and I am appearing here today on behalf of the Council of Housing Producers.

The council is made up of 15 of the largest producers of housing in the country, and they are concerned about some of the serious consequences which may result from the treatment that is being accorded to real estate in the House-passed measure.

I have a statement that I have filed for the record, Mr. Chairman, and I will summarize briefly the contents of that statement.

It was only about 14 months ago that there was signed into law the Housing Act of 1968 which was indeed a landmark piece of legislation, and which was termed the Magna Carta of Housing.

Here we are 14 months later worrying about how far we are going to miss in achieving the housing goals that were set in that basic legislation, and producing at about one-half the needed rate. It was at that time that Congress accepted the fact that we did have to have housing goals in this Nation and that over the next 10 years it would take 26 million dwelling units in order to meet the need. The goals were based on need.

The housing legislation of 1968 was to produce the tools for achieving those goals. We are already well behind in trying to meet the goals.

In January of this year housing starts were at an annual adjusted rate of about 1,900,000 units. In August of this year they had declined to about 1,300,000 units; more than a 30-percent drop. This is certainly no way to start meeting the goals which require aiming toward an annual rate of nearly 3 million units, and the bill which is before you now is going to be a further retarding measure if enacted.

The treatment which is being accorded the real estate industry can do nothing but depress an industry which already is depressed. The 30-percent decline in housing starts is going to decline further before the end of this year and unless there is a turnaround in the mortgage supply we can expect to approach the million mark.

Rather than seek methods of retarding housing further, I think that our principal objective ought to be how we can stimulate housing construction in order to meet this pent-up demand.

We now have the lowest vacancy rate in many of our major cities that we have had since the end of World War II. We have a vacancy rate in many major cities of less than 1 percent. We are in critical need of low- and moderate-income housing.

The programs that were established in the Housing Act of 1968 were, in large measure, aimed at nonprofit, limited-dividend, and cooperative sponsorship.

If we are to stimulate rental residential construction it will have to be through the stimulation caused through the limited-dividends route, and in the FHA programs the dividend on equity investment is limited to 6 percent.

In these days when high-grade corporate bonds are yielding in excess of 8 percent and yields on Governments approaching that amount, it is not hard to understand that you are going to have very few equity investors going in the program for a 6-percent limited-dividend return.

The reason that they have been active, the reason that they have participated, is because of the incentives that were created through the tax benefits, and if those incentives are removed you are also going to remove the risk capital of the equity investor.

The points to which I would like to address myself, and to mention to this committee, are in two principal areas. First, there is double declining depreciation permissible for new residential construction, but that really is not a tax benefit. It merely is a tax deferral, because the depreciation which is accelerated, that which is taken above straight line, is taxable at ordinary income rates rather than at capital gain rates when the property is sold, and it is taxable in full in the year of sale.

Secondly, the market on existing projects is going to be narrowed very, very sharply because the tax incentives are being taken away from existing projects since they could be depreciated only at straight line.

The investor who acquires an existing project is doing so on the basis of a yield that he expects to obtain. He expects to obtain some part of that yield, currently, through his cash flow and some part through his tax incentive. If he does not get it through the tax incentive there is only one other way that he can achieve the yield that he expects and requires for the risk equity that he puts in and that is through increased rentals. I believe that if you enact this tax bill you are going to see millions of rental units in this country which are going to have the rents raised very substantially, and it is going to hurt worse those people who can least afford it. These are the low- and moderate-income families in our country.

There are two other provisions in this bill that I would like to mention briefly for the consideration of this committee, Mr. Chairman.

One is the proposal on cutting back the depreciation on commercial construction. This is important to housing because commercial and residential go hand in hand, particularly in the development of outlying areas. In the development of new communities, if you can't get commercial property developed then it will not be possible to get residential property developed.

And the final point that I would like to ask the committee to consider carefully is that dealing with the tax treatment of thrift institutions. Mortgage credit is the lifeline of the housing industry, which already is depressed. Mortgage credit is in as short supply as it has been since the credit crunch of 1966, and the thrift institutions have been suffering by withdrawals into other more attractive forms of investment of their savings. They are being hit hard in this pending legislation, and we would urge the Congress to consider the impact that this, too, will have on housing.

We believe that the problem is to get on with the job of providing the housing that the families in this country need, and the council would urge the Congress to consider ways and means of improving the flow of mortgage credit and improving the mechanisms for providing housing rather than this present legislation which will indeed have the opposite effect, Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator CURTIS. Mr. Chairman, are we entitled to one question?

The CHAIRMAN. If you want to, go ahead.

Senator CURTIS. Is it true some savings and loan companies will have their tax doubled by this bill?

Mr. BROWNSTEIN. Senator Curtis, I have heard that it would be very substantial and would in some cases have that effect.

Senator CURTIS. That is all.

The CHAIRMAN. Thank you very much.

(Philip N. Brownstein's prepared statement follows:)

STATEMENT OF PHILIP N. BROWNSTEIN ON BEHALF OF THE COUNCIL OF HOUSING PRODUCERS

SUMMARY

Housing production is totally dependent upon capital availability. In the case of sales housing the need is primarily for mortgage credit. While this, of course, is equally true with respect to the production of rental housing, in the latter case there is the added need for long term equity capital. And this need for equity investors is what is concerning the Council in the tax measures now being considered by the Congress.

Of particular concern to the Council is the proposed elimination of accelerated depreciation on existing residential property and the treatment of recaptured equity as ordinary income to the extent that accelerated depreciation has been taken on new residential property during the period of initial ownership.

The Council is also concerned about the depreciation formula for commercial property. The lack of commercial facilities will seriously hamper the development of new areas, especially those in outlying regions and in new communities.

Since the life line of production of housing is mortgage credit and since the major suppliers of this credit, particularly for home financing, have been the thrift institutions, the Council would urge that this be considered when looking at the tax structure of these institutions.

STATEMENT

Mr. Chairman and members of the committee, I appreciate the opportunity of appearing here today on behalf of the Council of Housing Producers. The Council was founded in February, 1968, to provide leadership in the broader involvement by private industry with government in helping meet the Nation's housing needs. It is comprised of 15 of America's largest housing producers.

The Council completely supports the housing goals established in the Housing and Urban Development Act of 1968 and intends to use all of its resources in trying to see that these goals are achieved. It also supports Secretary Romney's efforts in Operation Breakthrough, and a number of members contemplate submitting proposals for consideration. We are hopeful this will demonstrate that relieved of some of the existing constraints and impediments, meaningful savings in housing construction may be achieved.

Housing, as you know, is always adversely affected disproportionately during periods of monetary restraint. This is now occurring, and as a consequence we are witnessing a substantial decline in housing starts instead of the increase needed to begin meeting our housing goals. The rosey pronouncements which accompanied the passage of the 1968 landmark legislation are indeed taking on a somber hue. Starts have dropped from an adjusted annual rate of nearly 1.9 million in January of this year to about 1.3 million in August. If the trend in the availability of mortgage credit is not promptly reversed, it is likely that by year end housing starts will have declined to even considerably lower levels.

Housing production is totally dependent upon capital availability. In the case of sales housing the need is primarily for mortgage credit. While this, of course, is equally true with respect to the production of rental housing, in the latter case there is the added need for long term equity capital. And this need for equity investors is what is concerning the council in the tax measures now being considered by the Congress.

The Council was gratified that the measure approved by the House recognized the need for continuing accelerated depreciation for new residential construction. Also, the encouragement given to rehabilitation by permitting the amortization of such expenditures over a 60 month period may stimulate activity in this important area which has too long been neglected.

Real estate investments by their very nature lack liquidity and carry a high degree of risk. It is fairly customary that during the early life of a rental project, during the so-called rent-up period, not only is no income generated but, in fact, the project often shows a deficit due to the excess of operating expenses over rents received. In the case of housing projects built under the subsidy programs of HUD and sponsored by limited dividend groups, the return to the investor is limited 6% on the amount of investment. With the yield on Government securities approaching 8% and on good grade corporate bonds exceeding that amount, it is clear that the attractiveness of HUD's limited dividend investment programs is not the cash return. This is also true to a large degree in conventional, non-subsidized projects. The interest of equity investors is sparked largely by the tax advantages which the investor receives. As a matter of fact, the National Corporation for Housing Partnerships, created by the 1968 Housing Act to assist in the production of low and moderate income-housing, and which is just getting underway, depends in great measure of the tax benefits to give its investors a satisfactory return. This was contemplated in the legislation, and it is the basis on which the incorporators and officers have proceeded.

The major concern of the Council with regard to the legislation under consideration is that relating to the depreciation provisions respecting residential property and with the tax treatment provided for recapture in the event of sale. But there are two other important provisions having a bearing on residential property production which will be mentioned briefly.

First, as indicated earlier, the life line of housing production is mortgage credit. The principal suppliers of this credit, especially in the home financing field, have been the thrift institutions—savings and loan associations and mutual savings banks. The effect of high returns on other investments, including government securities, has taken its toll on these institutions as they have suffered heavy withdrawals of savers' funds. This is being felt in the home building industry.

Financing commitments are difficult, and at time impossible, to obtain simply because funds are lacking. Undoubtedly these are matters which the Congress will want to consider when looking at the tax structure of these institutions.

Mortgage investments must be encouraged—not discouraged. To meet the housing goals Congress established by the 1968 Housing Act—26 million units during the next 10 years—capital must be attracted from other sources. The Ginny Mae collateralized mortgaged notes hopefully will attract new credit sources, such as pension and welfare funds, but the investment itself still must be attractive. The entire base of investment capital in housing must be widely broadened if these goals are to be met.

The second item in which we would like to touch is the depreciation formula for commercial property. Residential and commercial development often go hand in hand. In areas being newly developed, adequate commercial facilities are essential if residential construction is to proceed. If construction of commercial facilities should become unattractive to investors, it will seriously hamper the development of new areas, especially in outlying areas and in connection with the undertaking of new communities. We would urge that these considerations be given effect in determining the tax treatment to be accorded commercial real estate.

Of particular concern to the Council is the proposed elimination of accelerated depreciation on existing residential property and the treatment of recaptured equity as ordinary income to the extent that accelerated depreciation has been taken on new residential property during the period of initial ownership.

An investor is willing to risk the capital required to develop residential property only if the prospects for receiving what he believes is an adequate return are reasonably good. Inherent in the plans of many of those willing to supply the necessary equity capital is the contemplation of accelerating the depreciation allowance for a number of years in order to raise the effective yield from the investment to an amount reasonably commensurate with the risks and in keeping with the competitive demand for investment capital. Such plans further contemplate the sale of the property when this yield can no longer be obtained. This can be done because there is a ready market of other equity investors who are looking for investments which supplement a limited return with a tax benefit derived through property depreciation allowances. If the depreciation allowance is reduced and the investment accordingly is no longer as attractive as other investment opportunities, the market on existing projects will become quite limited. This being the case, investors will be most reluctant to undertake new projects knowing that when retention is no longer profitable there may be difficulty experienced in effecting a sale at a reasonable price.

This can have a very serious effect also on the existing supply of rental property. If investors are unable, in effect, to augment their yield through the allowance for depreciation, there is only one other way to increase the yield they believe their equity investment warrants. That would be by increasing rentals to compensate for the return which is otherwise lost. As a consequence, this could mean very substantial rent increases on the hundreds of thousands of rental units in which this would be an important factor. Very likely, the savings in tax to the individual through tax reform measures would be totally lost trough increased rents.

The tight rental housing market with which most areas are faced today, and indeed this is acute in some areas, very nearly eliminates any options on the part of the tenants to seek other accommodations. According to Census Bureau statistics available housing is at its lowest level since 1957 with the vacancy rated at 5% of the supply during the second quarter of this year for rental units and less than 1% for sales housing. Rental housing availability has been shrinking steadily from 7.7% in late 1965 and homeowner vacancies are off from 1.4% in 1966.

Faced with rent increases which must assuredly follow a decrease in the production of rental units, the public must either allot a disproportionate share of their income to shelter cost or possibly go into a substandard unit. The scarcity of available housing actually is a major contributing factor to inflation. Any move in the direction of further retarding housing production by discouraging private investment will certainly be counter productive by worsening the housing shortgage and forcing up rentals thus aggravating inflationary conditions.

The provisions in the House approved bill which would tax as ordinary income all or most of the gain on the sale of investment property, that is the amount attributable to the benefit derived from accelerated depreciation is equally serious. As a matter of fact, it virtually negates the advantage ostensibly given to the

production of new residential construction by permitting accelerated depreciation in the first instance. What it really does is merely defer the tax payment. Not only does it require the taxation of the accelerated depreciation at ordinary income rates, but the bill would also make the entire amount of deferred income payable in the year of sale. This large sum payable in one taxable year would be a further deterrent to equity investors. Given various investment alternatives, it is quite probable that much of the needed capital would be channeled to other sources.

The need is for an inducement to the equity investor to risk his capital so that we can begin a program of housing production which will meet our Nation's needs. Housing production, as pointed our earlier, is suffering from the effects of a restrictive monetary policy. To aggravate further this critical condition by superimposing tax laws which discourage the investment of equity capital in the housing industry could well create an imbalance in the economy of our country which will be borne by the segment of our population who can least afford it, that is the low and moderate-income family that must rent its shelter. We are well behind the production schedule necessary to be maintained in order to meet the 10 year housing goals. We can ill-afford additional impediments which will not only make the goals impossible of achievement in eliminating substandard housing, but may indeed help to bring about even more severe housing shortages in many areas.

The CHAIRMAN. The next witness is Mr. Joseph Sexton, chairman of the Federal legislative committee of the National Apartment Association.

STATEMENT OF JOSEPH F. SEXTON, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE, NATIONAL APARTMENT ASSOCIATION

Mr. SEXTON. I am Joseph Sexton of Indianapolis, Ind.

Mr. Chairman, and members of the Senate Finance Committee, I wish to take this opportunity to thank you for the privilege of appearing before you today on behalf of the National Apartment Association. It is an organization of some 16,000 members involved in the ownership and management of apartments throughout the United States.

Our general prepared testimony deals with the problems involved in our industry today and I wish to elaborate upon this as well as upon the tax bill as approved by the House of Representatives.

During the past 8 months housing starts in the United States have dropped from 1,900,000 to 1,340,000—a 35-percent drop. Because of this drop in production, vacancies in apartments, especially in the medium- and low-rent range (are almost nil at the present time. Our national housing goal was set at 2.6 million units by the Housing Act of 1968, which this Congress enacted.

The Douglas Commission on Urban Problems, the Kaiser Committee on Urban Housing, and the Joint Economic Committee, as recently as April of this year, have all recommended that added incentives be granted the housing industry to stimulate construction of single and multifamily residences. In the face of this, the pending tax reform bill would bring about a further reduction in starts of multifamily residential construction as well as rent increases for many American families.

The further reduction will be brought about because the returns to equity capital will be so greatly impaired by this law as to reduce capital investment in apartments. It would tend to flow to mortgages, bonds, and other forms of investment, which have as good or better yield without the corresponding risk.

Real estate, being a nonliquid asset is not looked upon with favor by equity investors as a desirable form of investment. It takes the tax incentives which are currently provided to stimulate this type of development.

The National Apartment Association recommends that H.R. 13270 be amended to retain the 150-percent declining balance method of depreciation on used apartments. The straight-line method is unrealistic in the light of the long useful lives which the Treasury has insisted upon, lives which do not reflect technological obsolescence. So unrealistic is the straight-line method, that denial of the 150-percent method will seriously limit the resale market, thereby discouraging the development of new multifamily projects.

Our association strongly objects to the harsh recapture provision in the House bill which would tax all the gain on the sale as ordinary income to the extent of the depreciation taken in excess of straight line. No attempt is made to differentiate between the short-term holder and the long-term investor; certainly this underscores how unreasonable is this provision. Our association recommends instead that during the first 5 years of the holding period the depreciation taken in excess of straight line be taxed as ordinary income but thereafter the percentage of gain taxed as ordinary income be reduced 1 percent per month. Certainly, one who holds property more than 13 years should be entitled to have all his gain taxed at capital gains rates.

We further recommend that, in view of the desire of our Government to stimulate more housing, reexamination of the limited tax preference penalties on real estate be examined.

The limit on tax preferences (LTP) was originally devised to prevent high-income persons from escaping taxation. As it has now been watered down, hobby farming may escape it by the use of accrual method of accounting; oil is exempted from it; in the bulk of the income from municipal bonds which is exempted, the Treasury has recommended elimination not only of any reference to State and municipal bonds but also the appreciated value of assets donated to charity. Thus, the prime target of the limited tax preference plan now turns out to be real estate, the one area in our economy which can stand the least the cutback which would inevitable result from the provisions in the House approved bill. While our economy grew at a rate in excess of 5 percent in the last 8 years and capital investment grew at a rate of almost 10 percent, housing starts grew at a rate of only one-half of 1 percent. If this proposed House bill is adopted in its present form it will create an economic condition in which the shortages will be further compounded, in which rents will be forced to rise because of a lack of adequate return to the investor.

This will cause extreme dislocation to our economy and will produce more people in need of subsidized housing, which is just the opposite of our national goal. Our goal should be an increase of supply through tax incentives, if necessary, rather than a reduction of supply through elimination of existing incentives.

Retention of existing law will hold down rental increases throughout the country except to the reasonable extent made necessary by increases in construction costs, land costs, and interest charges.

Real estate which had the least amount of claimed escape in dollars and the various problem areas presented by the Treasury Department has received the greatest amount of penalty at a time when all segments of Government feel that housing needs the greatest incentive.

We sincerely hope you will consider the following amendment:

1. Permit the 150-percent depreciation method for used income property.

2. Revise the recapture provision to provide that during the first 5 years of the holding period the depreciation taken in excess of straight line be taxed as ordinary income but thereafter the percentage of gain taxed as ordinary income be reduced by 1 percent per month.

3. Reexamine the limited tax preference penalties on real estate.

Your favorable action on these proposals we feel will be a great help in accomplishing our goal of providing adequate housing for the American society in the years to come.

Because of the limitations of time I respectfully request that the balance of my statement be incorporated in the record. Gentlemen, thank you.

The CHAIRMAN. Thank you very much, Mr. Sexton.

(Joseph F. Sexton's prepared statement follows:)

STATEMENT OF JOSEPH F. SEXTON, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE OF THE NATIONAL APARTMENT ASSOCIATION

STATEMENT

Mr. Chairman and Members of the Senate Finance Committee, I wish to take this opportunity to thank you for the privilege of appearing before you today on behalf of the National Apartment Association, an organization of some 16,000 members involved in the ownership and management of apartments throughout the United States.

Our general prepared testimony deals with the problems involved in our industry today and I wish to elaborate upon this as well as upon the tax bill as approved by the House of Representatives.

During the last 8 months, housing starts in the United States have dropped from 1,900,000 to 1,340,000—a 35% drop. Because of this drop in production, vacancies in apartments, especially in the low and moderate rent range, are almost nil at the present time. Our national housing goal was set at 2.6 million units by the Housing Act of 1968, which this Congress enacted.

The Douglas Commission on Urban Problems, the Kaiser Committee on Urban Housing, and the Joint Economic Committee, as recently as April of this year, have recommended that added incentives be granted the housing industry to stimulate construction of single and multi-family residences. In the face of this, the pending tax reform bill would bring a sharp reduction in starts of multi-family residential construction as well as rent increases for many American families.

This further reduction will be brought about because the returns to equity capital will be so greatly impaired by this law as to reduce capital investment in apartments. It would tend to flow to mortgages, bonds, and other forms of investment, which generally provide more yield without corresponding risk.

Real estate, being a non-liquid asset, is not looked upon with favor by equity investors as a desirable form of investment. It takes the tax incentives which are currently provided to stimulate this type of development.

The National Apartment Association recommends that H.R. 13270 be amended to retain the 150% declining balance method of depreciation on used apartments. The straight-line method is unrealistic in the light of the long useful lives which the Treasury has insisted upon, lives which do not reflect technological obsolescence. So unrealistic is the straight-line method, that denial of the 150% method will seriously limit the resale market thereby discouraging the development of new multi-family projects. The July 24th cut-off date has already had a serious impact by discouraging investors from purchasing apartments!

Our Association strongly objects to the harsh recapture provision in the House bill which would tax all the gain on the sale as ordinary income to the extent of the depreciation taken in excess of straight-line. *No attempt is made to differentiate between the short-term holder and the long-term investor; certainly,* *this underscores the unreasonableness of this provision.* Our Association recommends instead that during the first five years of the holding period the depreciation taken in excess of straight-line be taxed as ordinary income but thereafter the percentage of gain taxed as ordinary income be reduced 1% per month. Certainly, one who holds property more than thirteen years should be entitled to have all his gain taxed at capital gains rates.

We further recommend that in view of the desire of our government to stimulate more housing, re-examination of the limited tax preference penalties on real estate be examined.

The limit on tax preferences (LTP) was originally devised to prevent high income persons from escaping taxation. As it has now been watered down, hobby farming may escape it by the use of accrual method of accounting; oil is exempted from it; the bulk of the income from municipal bonds is exempted, the Treasury has recommended elimination not only of any reference to state and municipal bonds but also the appreciated value of assets donated to charity. Thus, the prime target of this area now turns out to be real estate, the one area in our economy which can stand the least the cut-back which would inevitably result from the provisions in the House-approved bill. While our economy grew at a rate in excess of 5% in the last 8 years and capital investment grew at a rate of almost 10%, housing starts grew at a rate of only ½ of 1%. If we do not stimulate housing, we will find a situation in which the shortages will be further compounded, in which rents will then be forced to rise because of lack of supply. This will cause extreme dislocation to our economy and will produce more people in need of subsidized housing which is just the opposite of our national goal. Our goal should be an increase of supply through tax incentives, if necessary, rather than a reduction through elimination of existing incentives.

Retention of existing law will hold down rental increases throughout the country except to the reasonable extent made necessary by increases in construction costs, land costs, and interest charges without the added problem of a market which has imbalance on the demand side which is now occuring.

It is indeed strange that real estate which had the least amount of claimed escape in dollars and the various problem areas presented by the Treasury Department has received the greatest amount of penalty at a time when all segments of government feel that housing needs the greatest incentive. We feel that your amending this legislation will enable us to accomplish our goal of providing adequate housing for all American families in the years to come.

Because of the limitation of time on this presentation I respectfully request that the balance of my statement be incorporated in the record.

The multi-family residential real estate industry

(a) *Scope of the Industry.* Multi-family residential real estate is a billion dollar industry in the United States. As of the end of 1968 there were 68,000,000 housing units in the United States, including both multi-family and single family units. The number of multi-family units (5 or more units under one roof) added annually over the past few years is as follows:

1966	345, 700
1967	392, 200
1968 (Value: $7,300,000,000)	548, 800

The apartment industry employs an enormous number of construction workers, consumes a huge amount of construction materials and employs many additional personnel as managers and operators of apartment projects.

The apartment industry is one of the significant areas in the American economy where the small businessman is a key factor. The typical apartment builder is a small businessman. Past experience has demonstrated that events having an adverse effect on the apartment industry (such as expensive or unavailable financing) not only have a serious effect on the tenant (Housing shortages and higher rents) and the apartment industry as a whole but have a particularly serious effect on the small builder. Big builders can ride out these problems. Small builders often cannot.

(b) *Typical Example of an Apartment Project.* In order to illustrate the applicability of the tax provisions involved to a typical apartment project, let me set forth an example of a typical residential project within my own experience. The figures on page 5 use a hypothetical 6% mortgage such as might have been obtained 2 or 3 years ago; the figures on page 6 use the actual 7½% mortgage committed for last summer. (Such a mortgage today would carry an interest rate of at least 8½%.)

81-UNIT APARTMENT PROJECT

Land	$175,000
Building	825,000
Total	1,000,000
Mortgage	750,000
Equity	250,000
Total	1,000,000

1ST YEAR, 6 PERCENT MORTGAGE, 8 PERCENT CONSTANT[1]

[Figures are rounded]

	Occupancy			
	100 percent	95 percent	90 percent	80 percent
1. Gross annual income	$160,000	$152,000	$144,000	$128,000
2. Operating expenses (not including debt service)	64,000	64,000	64,000	64,000
3. Net income (before debt service)	96,000	88,000	80,000	64,000
4. Interest on first mortgage	45,000	45,000	45,000	45,000
5. Net income (after interest deductions)	51,000	43,000	35,000	19,000
6. Depreciation (40 years, DDB)	41,250	41,250	41,250	41,250
7. Taxable income (5 less 6)	9,750	1,750	(6,250)	(22,250)
8. Mortgage amortization	15,000	15,000	15,000	15,000
9. Cash flow (5 less 8)	36,000	28,000	20,000	4,000
10. Return on equity (percent)	14.4	11.2	8.0	1.6

[1] Annual payments of principal and interest equal 8 percent of the original principal amount of the mortgage loan.

81-UNIT APARTMENT PROJECT

Land	$175,000
Building	825,000
Total	1,000,000
Mortgage	750,000
Equity	250,000
Total	1,000,000

1ST YEAR 7½-PERCENT MORTGAGE PLUS 2½ PERCENT OF GROSS[1]—9.1 PERCENT CONSTANT[2]
[Figures are rounded]

	Percent occupancy			
	100	95	90	80
1. Gross annual income	$160,000	$152,000	$144,000	$128,000
2. Operating expenses (not including debt service)	64,000	64,000	64,000	64,000
3. Net income (before debt service)	96,000	88,000	80,000	64,000
4. Interest on 1st mortgage	56,250	56,250	56,250	56,250
5. Net income (after interest deductions)	39,750	31,750	23,750	7,750
6. Depreciation (40 years, DDB)	41,250	41,250	41,250	41,250
7. Taxable income (5 less 6)	(1,500)	(9,500)	(17,500)	(33,500)
8. Mortgage amortization	12,000	12,000	12,000	12,000
9. Cash flow (before mortgagee share)	27,750	19,750	11,750	(4,250)
10. Less 2½ percent gross[1]	4,000	3,800	3,600	3,200
11. Cash flow	23,750	15,950	8,150	(7,450)
12. Return on equity (percent)	9.5	6.5	3.3	[3]

[1] The lender receives 2½ percent of the gross revenue as additional interest over and above the 7½ percent.
[2] Annual payments of principal and interest equal 9.1 percent of the original principal amount of the mortgage loan.
[3] Negative.

Note: The foregoing example illustrates a number of points which are typical of multifamily real estate.

(1) The net return to the investor is very sensitive to changes in occupancy. A drop from 95% occupancy to 80% occupancy reduces an 11.2% return with a 6% mortgage to 1.6% and reduces a 6.5% return with the 7½% mortgage to a cash loss of $7,450.

(2) The net return to the investor is also very sensitive to financing changes, shifting from a 6% to the 7½% mortgage drops the return at 95% occupancy from 11.2% to 6.5% and at 90% occupancy from 8% to 3.3%.

(3) Variations in operating expenses can have a significant effect. For example, 40% of the gross income has been used as the estimate of operating expenses. I know of instances in which actual operating expenses have been higher. Furthermore, when there are vacancies, operating expenses are often even higher because of turnover expenses such as repainting.

(4) From the time land is contracted for until cash flow begins will take a minimum of 18 months to 2 years during which land must be acquired, the site developed, the building constructed and rented. During that period of time, the investor gets no return on his investment and runs the highest risk that something may go wrong which may prevent completion of the project.

(5) If the House-approved bill is enacted without change, the marginal investment (maximum 9.5% return plus some tax benefits) described in the example on p. 6 would be even less attractive with these results: (1) rents would have to be higher on new projects to justify such an investment and (2) many such projects would not be built, with these further consequences: (a) an increased housing shortage, (b) higher rents on existing projects, and (c) more tenants now in non-subsidized housing would be forced into subsidized housing.

(c) *Recent Trends.* The Committee will recall the credit crunch of 1966 when it became clear that there was a significant shortage of capital in the United States, one result of which was that interest rates rose sharply in a trend which is continuing. This shortage of capital continues today. The result is and has been hardship for many areas of American business but the heaviest burden has fallen upon the real estate industry which has found sharply increased costs for financing when it was available and that traditional sources of mortgage financing began allocating more funds to areas other than real estate where they could get higher or equal returns on a shorter term basis with less risk, less bother and less administrative expense.

When a recent Wall Street Journal article is headed "Housing Shortage is Worst in 20 Years, Survey Finds," (3/7/69) if the tax provisions are to be modified they should be made more favorable to real estate investment.

(d) *Capital Supply.* Funds for the acquisition of land and construction of apartments come from two sources, funds lent by mortgage lenders and risk equity capital put up by investors. The apartment industry competes with all other industries in the United States for capital funds. Whenf bonds of good publicly traded corporations, which are readily marketable and salable on a day-to-day basis and which are commanding returns as high as 7% are available, many funds which would otherwise flow into real estate mortgages at 8% or 8½% will instead flow into these corporate obligations. Similarly, when investors who might otherwise invest in real estate equities get returns of 7%–8% on corporate obligations and 8% on first mortgages which have substantially less risk than equity capital, funds tend to shift away from equity investment. Without the risk capital of the equity investor it is not possible to build apartment units. Present financial trends in the United States have combined to cause a slow down in the flow of both mortgage funds and risk equity capital to the apartment industry thereby holding back needed apartment construction.

What does the risk capital equity real estate investor obtain for his investment? To attract this capital today when he could get an 8% return on a first mortgage and a 10 or 11% return on a commercial real estate investment the equity investor in apartment projects is looking for a 12% or better cash return on his investment. At the same time, it should not be overlooked that the owner of an equity interest in an apartment project has a non-liquid asset. It is not traded on an exchange or over the counter. It may or may not be readily salable. When things are going well, when apartments are full, when vacancies are low, when rental income is adequate in relation to operating costs, when apartments have waiting lists, then equity interests in apartments can be sold relatively easily. However, as any of these factors start to soften, the situation changes sharply and in years when the operating costs have increased much more sharply than rents have increased, when financing costs and real estate taxes have increased more than rents have increased or when significant vacancies develop, the real estate investor finds that his investment is either not salable or salable only at a loss. The non-liquid nature of the investment significantly increases the risk.

Fortunately, under the tax laws equity investors in real estate find tax benefits which have helped to attract the risk equity capital which has made possible the construction of the apartment units which have been built over the last several years. Given the serious disadvantages which real estate has in raising capital as compared to other forms of capital investment, if these rules were changed adversely to real estate it would be even more difficult to obtain capital and fewer units would be built, with serious adverse consequences not only to tenants seeking housing but also to the many persons employed in the construction of apartments. Some of the large corporations engaged in building apartments would still be able to withstand these trends, but the typical small builder of apartments would not. In our considered opinion the elimination of accelerated depreciation on new construction and elimination of the 150% method on existing apartments would result in a sharp cut back of rental housing with a serious housing shortage as well as increased rentals as an inevitable consequence.

THE RESIDENTIAL HOUSING SUPPLY AND TAXES

(a) *The Housing and Urban Development Act of 1968.* § 1601 of the Housing and Urban Development Act of 1968 provides:

"The Congress finds that the supply of the Nation's housing is not increasing rapidly enough to meet the national housing goal, established in the Housing Act of 1949, of the 'realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family'. The Congress reaffirms this national housing goal and determines that it can be substantially achieved within the next decade by the construction or rehabilitation of twenty-six million housing units, six million of these for low and moderate income families."

In 1968, 1,500,000 housing units were produced and it is estimated that 1,600,000 to 1,700,000 will be produced in 1969. Accordingly, under the present system we are already falling a 1,000,000 units a year short of the national goal for the current period. Actual production of housing units is only approximately 60% of the national goal.

Of the national goal of 2,600,000 units per year 600,000 units are to be low and middle income housing and 2,000,000 other housing. Not only are we not achieving the goals with respect to production of low and middle income housing but we are far short of achieving the overall goal of total housing units. The current financial and capital picture as indicated above is such that the outlook does not look good for the future in terms of expanding the units produced, even if the present tax rules are left the way they have been for 15 years. We believe that when other Federal laws are being designed to encourage housing production, it would be unsound public policy to change the tax rules to make real estate investment less attractive.

(b) *National Commission on Urban Problems (Douglas Commission).* The National Commission on Urban Problems, chaired by former Senator Paul Douglas, has made an extensive study of urban problems including housing. One of its statutory assignments was a study of "tax policies with respect to their effect on land and property cost and on incentives to build housing and make improvements in existing structures."

Federal taxation as it relates to housing is discussed in Chapter 7, "Federal Income Taxation and Urban Housing" which is contained in Part IV of the Report, Investment Structure, Finance and Taxation.

The Commission concluded (p. 7–10):

"(1) That special tax preferences should not be relied upon as the sole or even the primary instrument to deal with urban housing problems;

(2) That, however, some changes in Federal income tax laws and regulations should be made as soon as possible; and

(3) That there should be vigorous official exploration of certain other potentially significant changes that might improve the tax climate for urban housing."

The Commission also stated (p. 7–10):

". . . [o]ur special concern here is with the effect of present arrangements upon incentives for investment in housing, and it seems clear (1) That existing tax provisions have been 'institutionalized' into a complex set of economic relationships that involve a large volume of investment as well as the provision of rental housing for about one-third of all American families; and (2) That any 'loophole-closing' efforts, if applied only or more strenuously to this than to other competitive investment fields, would probably curtail the flow of resources and managerial efforts into this area. . . ."

The Commission made three recommendations (Report, part IV, Investment Structure, Finance, and Taxation, chapter 7, "Federal Income Taxation and Urban Housing", pp. 7-20-7-22):

1. The Commission recommends that the President direct the Treasury Department to make an intensive analysis and submit explicit findings and recommendations concerning tax law changes best suited to provide materially more favorable treatment for investment in new residential construction (including major rehabilitation) than for other forms of real estate investment.

2. The Commission recommends that the Internal Revenue Code be amended to provide specific incentives for adequate maintenance and rehabilitation of rental residential property by allowing, within appropriate limits, for especially generous tax treatment of investor-owners' expenditures for these purposes with respect to structures of more than some specified age, such as 30 or 40 years.

3. The Commission recommends prompt revision of the Federal income tax laws to provide increased incentives for investment in low- and moderate-income housing, relative to other real estate investment, where such housing is governmentally subsidized and involves a legal limit upon the allowable return on investors' equity capital. Specifically, we propose that the Internal Revenue Code be amended to provide especially favorable treatment (whether through preferential depreciation allowances or through investment credits) for investments made under governmentally-aided limited-profit programs for the construction and rehabilitation of low- and moderate-income housing.

We endorse the three recommendations of the Commission. If our national housing goals are to be met, new incentives must be found for new residential construction. Special incentives are also appropriate for low and middle income housing. It seems to us that the investment credit is a tested method of tax incentive through which this incentive for low and middle income housing could be provided.

(c) *The President's Committee on Urban Housing.* On December 11, 1968 the President's Committee on Urban Housing under the chairmanship of Edward F. Kaiser submitted its final report. This Committee had submitted various reports from June of 1967 to that date and made recommendations which became part of the Housing and Urban Development Act of 1968.

One of the major goals which the Committee seeks to reach is to encourage new investment in low and middle income housing. This was one of the purposes of the National Housing Partnership established by the Housing and Urban Development Act of 1968. To reach this goal the Committee relies heavily on tax incentives.

This point can be illustrated by the Kaiser Committee's discussion of § 221 (d)(3) of the National Housing Act. Under that provision a profit sponsor can be set up on a limited dividend basis, can obtain a 90% mortgage insured by FHA, but is limited to a net cash return of 6% on the 10% equity. The report points out that this return is so low that it would not be at all attractive to investors without the Federal income tax benefits under existing law. Furthermore, even with the current tax benefits under existing law the yield is made substantially more disadvantageous by the existing provisions taxing gain on sale (as long term capital gain except to the extent of ordinary income arising from the recapture of depreciation rules of § 1250). Table 2-6 shows yield in relation to tax bracket, disregarding tax on sale. Table 2-7 shows how the yield is reduced because of the tax on gain on sale.

TABLE 2-6.—CUMULATIVE AVERAGE AFTER-TAX YIELD (INCLUDING 6-PERCENT CASH RETURN AND TAX SAVING) ON INVESTMENT OF $408,000[1] (221(d)(3) BELOW MARKET INTEREST RATE PROJECT) FOR INVESTORS IN 30-, 50-, AND 70-PERCENT BRACKET IGNORING TAX CONSEQUENCES ON SALE

Years before sale[2]	Yield for taxpayer 30-percent bracket			Yield for taxpayer 50-percent bracket			Yield for taxpayer 70-percent bracket		
	Annual return[3]	Discount[4] (percent)	Average[5] (percent)	Annual return[3]	Discount[4] (percent)	Average[5] (percent)	Annual return[3]	Discount[4] (percent)	Average (percent)
1	$77,000		18.9	$128,300		31.4	$179,600		44.0
2	38,600	14.5	1'.2	64,000	24.4	23.6	90,100	37.7	33.1
3	49,800		13.5	66,600		21.1	83,400		28.8
4	46,900		13.0	61,800		19.7	76,700		26.3
5	44,100	12.9	12.6	57,200	19.9	18.5	70,200	27.4	24.5
6	39,700		12.1	49,900		17.5	60,000		22.8
7	37,100		11.7	45,500		16.6	54,000		21.5
8	34,600		11.3	41,400		15.8	48,200		20.3
9	32,200		10.9	37,400		15.0	42,500		19.2
10	29,900	11.3	10.5	33,500	16.8	14.4	37,000	23.2	18.2
11	27,600		10.2	29,700		13.7	31,700		17.2
12	25,400		9.9	26,000		13.1	26,600		16.3
13	23,300		9.5	22,400		12.5	21,600		15.5
14	21,200		9.2	19,000		12.0	16,800		14.7
15	19,200	10.2	8.9	15,600	15.0	11.4	12,100	21.2	13.9
16	17,200		8.6	12,300		10.9	7,500		13.1
17	15,300		8.3	9,100		10.4	3,000		12.4
18	13,500		8.1	6,000		9.9	(1,400)		11.7
19	11,600		7.8	2,900		9.4	(5,700)		11.0
20	9,800	9.4	7.5	(100)	13.8	8.9	(9,900)	20.0	10.3

[1] If real equity is less than $408,000, yields would increase proportionately. Assumes that return is received annually, and that entire equity investment must be made at the beginning of construction.
[2] Assumes 1-year construction period and 1-year break even period.
[3] "Annual return" is the sum of columns A (net cash income) plus applicable column B, C, or D (tax savings) in the table in appendix H-2.
[4] "Discount" represents the average cumulative rate of return on the $408,000 equity, discounted in accordance with accepted financial practice.
[5] "Average" represents the average cumulative rate of return on the $408,000 equity, not discounted.

TABLE 2-7. EFFECT OF TAX ON SALE[1] OF 221(d)(3) BMIR PROJECT ON YIELD,[2] TAXPAYER IN 50-PERCENT TAX BRACKET

	After tax rate of return before sale[3] in percent		After tax rate of return after sale[4] in percent	
	Discount	Average	Discount	Average
Sale after 2 years	24.4	23.6	3.3	3.3
Sale after 5 years	19.9	18.5	5.8	4.5
Sale after 10 years	16.8	14.4	9.7	5.6
Sale after 15 years	15.0	11.4	10.7	4.7
Sale after 20 years	13.8	8.9	11.0	3.5

[1] The sale price is assumed equivalent to the unamortized mortgage amount which would be outstanding had the project initially received 100-percent mortgage financing.
[2] If real equity is less tha $408,000, yields would increase proportionately.
[3] See table 3-4.
[4] Table 3-4 yields reduced by tax counsequences of sale. See appendix H-3.

Accordingly, the report concludes that existing tax provisions are not sufficiently beneficial to the investor to make the project sufficiently attractive and recommends that either the tax to be paid on sale should be added to the sale price which FHA can recognize in the case of a sale of a project to a cooperative condominium or noprofit organization, or that a 3% tax credit of the total replacement cost of the project be provided as an additional incentive or that the tax laws be amended to limit the taxable gain on sale to the amount by which the sale price exceeds the original value of the project, that is equity plus original mortgage. This last approach would mean that there would be no recapture, even at capital gain rates, of depreciation deductions. In other words, the Kaiser Committee concludes that many of the existing tax rules are an important affirmative incentive for investment in low- and middle-income housing, but that some of the existing tax rules discourage such investment.

(d) *The Treasury Study.* Under date of February 5, 1969, there was published a three volume document of the Treasury Department entitled "Tax Reform Studies and Proposals" (herin called Treasury Study). While it contains a large number of proposals involving changes in many areas of the Code, no proposals are made with respect to accelerated depreciation (or for that matter with respect to real estate) except for the proposal with respect to Subchapter S which is discussed below. (pp. 29–30)

Treasury made extensive recommendations in 1961 and 1963 with respect to real estate (which were rejected totally by the Congress in the 1962 Revenue Act and were substantially rejected by the Congress in the 1964 Revenue Act). We think it is significant that after four more years of study by Treasury, including contract studies by economists at the University of California (Treasury Study, p. 451), Treasury made no recommendations. Incidentally, we think the results of the study by the California economists should be made public.

The Treasury Study stated the impossibility of making reliable quantitative estimates of the effect of the tax laws on construction and housing supply in the present state of the economic art. (p. 442). It will be recalled that the Douglas Commission expressed concern that restrictive changes in the existing institutionalized tax provisions would curtail the flow of resources and managerial efforts into housing (see p. 11 above).

In part three of the Treasury Study from pages 438 through 458 under the heading IX C Supplementary Material: Tax Treatment of Real Estate there appears a good bit of material in connection with real estate taxation, but there are no recommendations.

The Treasury Study is devoted solely to the tax effects of current law on real estate situations and does not consider the influence of these tax factors on the housing supply. Both the National Commission on Urban Problems (the Douglas Commission) and the President's Committee on Urban Housing (the Kaiser Committee) considered not only the tax provisions but the effect of the tax provisions on the housing supply. Both of these reports recommend adding additional incentives in certain areas of housing and do not recommend any restrictive changes in any of the existing real estate tax provisions. We think it is highly significant that two independent studies which were concerned with the total picture (the relationship of the tax provisions to the housing supply) and were not concentrating solely on the tax aspects alone have come to two general conclusions which are the same, although some of their specific proposals differ:

(1) No change adverse to the real estate investor should be made in the existing rules;

(2) Additional tax incentives in certain areas of real estate are desirable.

The Treasury Study (pp. 451–458) sets forth figures with respect to (1) 14 real estate operators, (2) 19 real estate investors and (3) 17 real estate owners who sold real estate. The figures given do not indicate that the combination of tax losses and cash profits which resulted in many of these instances were the product of accelerated depreciation rather than other factors, such as itemized deductions and the deduction for long term capital gain. Furthermore, these figures relate to only a few taxpayers selected by the Treasury out of the thousands of returns analyzed by its statisticians.

We believe that it would be an enormous mistake to make basic changes in the tax provisions affecting real estate in order to take care of a situation involving a few taxpayers. The information furnished by the Treasury Department in the Treasury Study does not justify across-the-board changes which would adversely affect hundreds of thousands of taxpayers.

The Treasury Study (p. 442) estimates the revenue cost of accelerated depreciation for residential real estate (apparently including both 150% declining balance and other accelerated depreciation) at $250,000,000 broken down (1) $100,000,000 for older housing, (2) $100,000,000 for semi-luxury and luxury high rise construction and (3) $50,000,000 for low and moderate income housing. Presumably, the second category, although labelled "semi-luxury and luxury high rise" must also include middle income garden apartments, since they do not fit either of the other categories.

EXISTING TAX DISCRIMINATION AGAINST REAL ESTATE

There are two important respects in which the current tax rules discriminate against real estate, the first involves the area of useful lives and the second relates to the investment credit.

USEFUL LIVES

In 1962 when the Treasury Department published depreciation guidelines, Rev. Proc. 62–21, 1962–2 C.B. 418, the useful lives contained therein substantially lowered the useful lives of depreciable assets contained in Bulletin F *except in the case of real estate other than farm real estate:*

	Bulletin F (good-average construction)	Guidelines	Change in useful lives
Apartments	40	40	No change.
Farm buildings	50	25	100-percent reduction.
Office buildings	40-45	45	Increase.

The Treasury position was that unless there were to be full ordinary income recapture of real estate depreciation the useful lives would not be shortened.[1] We believe that it is wrong in principle to deny real estate fair and appropriate useful lives merely because Treasury has been unable to persuade Congress to change the tax laws in another respect which has nothing to do with useful lives.[2]

Many examples can be given to illustrate the incorrectness of the guidelines lives: for example, apartment projects built 10 or 15 years ago without swimming pools and/or without air conditioning are today obsolescent and are unable to compete economically with newer projects. Consider the many apartment projects built after World War II under § 608 of the National Housing Act, most of which are today obsolete.

ACCELERATED DEPRECIATION

Section 167(a) of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of income producing property. A substantially similar provision has been in the Code since the Revenue Act of 1913.

With respect to short-lived assets straight line depreciation often represents an economically appropriate reasonable allowance for depreciation. In the case of long-lived assets, such as apartment buildings, straight line depreciation would not cause a proper reflection of annual income where the property is held for many years. In the early years there is realistically a larger annual charge for depreciation (especially for obsolescense) as compared to later years. Accordingly, accelerated depreciation is appropriate for real estate. *This fact has been continually recognized administratively by the Internal Revenue Service for twenty-three years.*

Without benefit of specific statutory authority referring to the use of a declining balance method of depreciation, as early as 1927[3] the Internal Revenue Service recognized the existence of such method. Since 1946,[4] the Internal Revenue Service has recognized that a reasonable allowance for depreciation includes depreciation computed on the declining balance method. In a private ruling in 1946, the Internal Revenue Service approved 150% declining balance depreciation for buildings.[5]

In the Internal Revenue Code of 1954 additional accelerated depreciation was extended by statute to new property, including buildings,[6] up to a maximum of

[1] "Since no action was taken by the Congress to provide recapture of excess depreciation on real estate, the administrative revision of depreciation guidelines in 1962 was confined, in effect, to personal property. While guideline lives were provided for buildings, they were essentially the same as those in Bulletin F with the exception of farm buildings." (Treasury Study, page 447.)

[2] An administrative problem which needs to be improved is persistent reexamining by revenue agents of useful lives and changes in useful lives just 2 or 3 years after another agent, in an extensive examination, has adjusted useful lives. I know of a case where the present agent is trying to increase lives from 30 to 60 years where another agent established them just a few years ago. Ths has the effect of repealing double declining balance depreciation by revenue agent action.

[3] I.T. 2369, VI–2 C.B. 63 (1927).

[4] I.T. 3818, 1946–2 C.B. 42.

[5] Special ruling, August 30, 1946, 4 CCH 1946 SFTR 6273.

[6] See H. Rept. No. 1337, 83d Cong., 2d Sess. (1954), p. 23; the 200% declining balance method was provided by the 1954 Code for "rental housing and industrial and commercial building" as well as machinery and equipment.

200% declining balance. The Committee Report,[7] Regulations[8] and a published ruling[9] recognize that 150% declining balance had been available under prior law.

In 1964, in response to Treasury criticism that there was a tax abuse where taxpayers took accelerated depreciation and then disposed of the property in a relatively short time, the Congress enacted § 1250 which provides recapture of all or some real estate depreciation, varying with the holding period of the asset. § 1245 provides total recapture of depreciation for machinery and equipment, unrelated to holding period. Unlike machinery and equipment, real estate is (A) long-lived, not short-lived and (B) owned to a significant extent by individuals subject to sharply progressive income tax rates (14 to 70% without the surcharge). Thus, the § 1245 treatment which applies to relatively short-lived assets substantially owned by corporations is inappropriate for real estate.

The Treasury Study contains no information on what the experience has been under § 1250, which has now been in effect over five years.

The term accelerated depreciation is often used to refer to any depreciation in excess of straight line. In the interest of clarity of thinking, two different kinds of accelerated depreciation need to be distinguished, the accelerated depreciation up to 150% declining balance administratively recognized by the Internal Revenue Service for 23 years as being a reasonable allowance for depreciation and the special accelerated depreciation added by statute in the Internal Revenue Code of 1954 for new property up to 200% declining balance.

An apartment is never worth more *physically* than on the day it opens its door. Thereafter, its equipment is old and it is subjected to falling behind in the development of the art. Refrigerator sizes become larger, air conditioning is introduced, swimming pools are added, new types of carpet come in. The constant changes in equipment and furnishings for an apartment are such that any apartment in the first few years of its life suffers substantially more than straight line depreciation as a matter of economics. This can be illustrated many ways. For example, new apartments tend to have dishwashers; older apartments do not. The cubic foot area of refrigerators has expanded substantially over the years. Projects which are ten years old may have 6 cubic foot refrigerators whereas projects which are being done now have 12 or 15 cubic foot refrigerators. A person looking for a new apartment will naturally tend to prefer one which has the larger capacity refrigerator and a dishwasher. The older apartment project is at a significant competitive disadvantage as compared to the new project.

In the current economy depreciable real property which has been held for many years is often sold at a gain. It is incorrect to assume that this gain demonstrates that the depreciation was excessive. To the contrary, the gain is generally the product of either or both inflation[10] of the price level and increase in the value of non-depreciable land which is a clear capital gains.

The Treasury Study argues that present tax laws encourage frequent turnover of properties and, *therefore*, cause inadequate maintenance. page 443) This conclusion appears to rest on two assumptions: (1) the owner who is holding the property for a longer period will maintain the property well; and (2) the owner who is holding the property for a shorter period will not maintain his property

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[7] "Under this method [the declining balance method] a uniform rate is applied to unrecovered basis of the asset. Since the basis is always reduced by prior depreciation, the rate is applied to a constantly declining basis. The salvage value is not deducted from the basis prior to applying the rate, snce under this method at the expiration of useful life there remains an undepreciated balance which represents salvage value. The rate to be used under this paragraph may never exceed twice the rate which would have been used had the deduction been computed under the method described in paragraph (1). Under section 23(l) of the 1939 Code the declining balance method was allowed in certain instances but the rate was generally limited to one and one-half times of the rate used under the straight-line method. If this method has been used for property acquired prior to December 31, 1953, it may continue to be used but the rate provided for in paragraph (2) will not be presumed to be reasonable with respect to such property. . . ." H. Rept. No. 1337, 83d Cong., 2d Sess. (1954), p. A48. (As is noted, accelerated depreciation also avoids the salvage value controversy and never results in deductions in excess of basis, which is generally cost.)

[8] Reg. § 1.167(b)-0(b).

[9] Rev. Rul. 57-352, 1957-2 C.B. 150.

[10] It was for this reason that this Committee, in 1962, decided not to act on a Treasury recommendation for full recapture of real estate depreciation. " . . . Your Committee decided not to apply this treatment to buildings or structural components of buildings at this time because testimony before your Committee indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period. . . ." H. Rept. No. 1447, 87th Cong., 2d Sess. (1962), p. 67.

well. Both assumptions are incorrect. The ultimate test of the quality of a property is how it fares on sale in the market place. It is precisely the owner who is going to sell who must maintain his property; if he does not, he will either be unable to sell or he will have to take a substantial discount of poor maintenance. It is precisely the owner who is going to hold for a long time who can skimp on maintenance, doing only enough to keep tenants minimally satisfied.

For these reasons we urge the Committee to amend H.R. 13270 to retain the 150% method for existing apartments, and to modify the harsh recapture provision in accordance with the recommendation made on pages 1–2 of this statement.

The CHAIRMAN. Mr. Carter Burgess.

STATEMENT OF CARTER L. BURGESS, CHAIRMAN, NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

Mr. BURGESS. Mr. Chairman, my name is Carter Burgess. I am Chairman of the National Corporation for Housing Partnerships, and I am pleased to have with me today Ray Watt, who is president of this corporation.

We have filed our statement with the committee, and I would just like to review a few of the highlights.

As this committee knows, the National Corporation for Housing Partnerships was authorized by title IX of the Housing and Urban Development Act of 1968. In that same act, Congress ordained or set a goal for the Nation of the construction or rehabilitation of 26 million new housing units by 1978. Of that 26 million units, 6 million are for low- or moderate-income housing.

Our corporation was formed to help give attention and leadership to that low and moderate effort.

We look to corporations at the national level—industrial corporations, financial institutions, labor organizations—to give us the investment funds we need to develop low- and moderate-income housing in cooperation with local developers and investors.

Our national partnership also looks to the local communities of our country where individual investment is very important to the production of housing for low- and moderate-income families.

Mr. Brownstein before me has made many of the same points that we make in our formal statement. And I will try to summarize the details specified in our statement.

I think the main situation that this committee and this Congress has to look at is that the achievement of these goals, and praticularly the 6 million low and moderate goal which is of primary interest to the partnership, depends on the incentives that are on the books today. If the bill you are considering is introduced, these needed incentives are going to be lessened and weakened.

In broad strokes, the bill will affect depreciation and the taxation of that depreciation from our corporate investors standpoint. And, in the case of the individual investors at the local community level, the bill is going to adversely affect them not only through the change in the section 1250 recapture provision, but it will add additional taxation through the limited tax preference and the allocation of deductions. If there are some further adverse interpretations of other technical provisions of the law such as hobby losses, the treatment of interest deductions, both in the construction and investment areas, there will be further lowering of yield to the individual investor. Hanging over all of this, for both corporate and individual investors, is the increase in capital gains.

So my thought to this committee, sir, is that the laws on the books today are not giving you the performance in housing that you want. A weakening, a reduction of the incentives contained in the current laws may seriously impede the achievement of the goal you set in 1968. It certainly is going to hamper the performance of our partnership. We haven't even raised our corporate investment yet and we have high hopes for it.

In conclusion, I would say in the base of the low and moderate area, in particular, either try to give us as much of what existed on the books when we were founded, or if not, there is a proposal in our statement that would provide for certain tax forgiveness upon sale in the publicly assisted low and moderate area. As detailed in our statement, any gain over project cost would still be taxed at capital gain rates.

If you accept the provisions in the bill you must give us this or a similar substitute incentive so that we can hasten ownership for the low and moderate families and, at the same time, not increase the rents.

The CHAIRMAN. What you are saying here, I have read most of your statement while you were summarizing it, what you are saying here is we passed a law saying we want more housing and if we are serious about it we shouldn't pass a tax law to prevent that from happening.

Mr. BURGESS. That is correct.

The CHAIRMAN. Thank you very much, sir.

Mr. BURGESS. Thank you, Mr. Chairman.

(Mr. Burgess' prepared statement follows:)

STATEMENT OF CARTER L. BURGESS, NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

SUMMARY

Private investment in the development of low and moderate income housing currently depends upon aid provided through both the existing federal income tax treatment of real estate and the federal housing subsidy programs. The changes in present tax law contained in H.R. 13270 will eliminate much of the incentive for equity investment in low and moderate income housing and substantially reduce entrepreneurial interest in this housing.

Although the bill recognizes a distinction between new housing and other real estate development, it jeopardizes the Congress's efforts to promote the private development of politically assisted housing and the sales of such housing to low and moderate income tenants and tenant-oriented organizations.

Significantly, this comes at a time when the nation faces its greatest housing shortage since the immediate post-war years and when the demand for housing by lower income families is particularly acute.

In the Housing Act of 1968 Congress established the goal of the construction or rehabilitation of 26 million housing units, including 6 million publicly assisted units, by 1978. If Congress wishes to achieve these goals, it must not eliminate these tax incentives—at least until it provides a suitable substitute. Since the existing incentives have barely been effective, if private, rather than direct governmental action is to produce decent low and moderate income housing in volume, Congress should, at a minimum, create a new stimulus to development.

It is suggested that H.R. 13270 be amended to provide that upon the sale of a publicly assisted low or moderate income housing project to or for the benefit of persons of low and moderate income, the seller would recognize gain for federal income tax purposes only to the extent that the amount realized on such sale exceeds the cost as determined under Section 1012 of the Internal Revenue Code. Such action by the Committee would maintain or increase the continued interest of private enterprise in the development of low and moderate income housing without any significant loss of revenue and without disturbing the other goals sought to be achieved by the Tax Reform Act of 1969.

STATEMENT

Mr. Chairman and Members of the Committee: My name is Carter L. Burgess. I submit this statement as Chairman of the National Corporation for Housing Partnerships. The Corporation was established pursuant to Title IX of the Housing and Urban Development Act of 1968 as a method of involving American industry more substantially in the national effort to increase the quantity and quality of housing for low and moderate income families.

The Tax Reform Act of 1969, H.R. 13270, substantially modifies current provisions of the Internal Revenue Code related to housing production. In these respects, the Bill jeopardizes Congressional efforts, built upon the combination of federal tax incentives and subsidies, to promote the private development of low and moderate income housing and the sale of this housing to tenants and tenant-oriented organizations. Unless an effective and suitable substitute is adopted, the Corporation opposes the introduction of several of these new provisions.

National Housing Needs

In the Housing Act of 1968, Congress found that its promise of a generation ago to achieve the goal of a decent home and a suitable living environment ". . . has not been fully realized for many of the nation's lower income families." To fulfill this obligation and to meet the growing demand for housing, the 1968 Act set a national goal for the next decade of ". . . the

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In the year that has passed since the establishment of the national goals, the production of housing, especially low and moderate income housing, has decreased and today the nation faces one of the greatest housing crises in its history. Under the twin pressures of faltering production and rising family formations, vacancy rates have declined sharply.

Mortgage money is limited and its cost is high. Savings flow away from the traditional institutions that finance housing. Costs of land, labor and materials keep spiraling. And, most important, the equity, or "risk" capital, needed to genterate housing production grows scarce, especially for publicly assisted housing. As a result, housing starts by year-end may fall below the one-million level for the first time since 1946. At current rates of production, the nation will be more than 10,000,000 units short of the 26 million goal.

The need for more multifamily rental housing is particularly acute. Rental housing presently accounts for more than 40% of all housing starts. Heavy demand for this housing is already reflected in rapidly rising rents and falling vacancy rates. In Chicago and New York City, rental vacancy rates, for example, are currently below 1%. Given our very rapid urban growth, and the increasing costs of land, labor and material, multifamily rental housing will continue to gain importance in the national housing market. Of the 20 million unassisted units Congress sought to have built or rehabilitated by 1978, nine million are to be multifamily.

Nowhere is the shortage worse than in the area of low and moderate income housing. Today, 20 million Americans live in substandard, overcrowded dewellings. In sharp contrast to the national average of 15%, the poor pay 35% of their gross income for housing. One out of every eight American families cannot pay the market price of housing with 20% of its income. Yet, in 1969, the first year of the ten-year program, the Department of Housing and Urban Development projects only 135,000 publicly assisted units will be produced as compared to the 225,000 unit goal. Moreover, it is precisely in this field that multifamily rental housing will play its most important role. Of the 6 million publicly assisted new units called for over the next decade, 3,000,000 are to be privately owned, rental units.

Public incentives for private production

Private investment and development has produced almost our entire stock of multifamily rental housing. Congress has determined that in the area of publicly assisted rental housing, the private sector should continue to have the major production responsibility. This was made clear in the Housing Act of 1968. To achieve the goal of 6 million new and rehabilitated homes for low and moderate income families, Congress had a choice between

> Programs built upon the existing system of private construction and ownership, aided and regulated by the government but operated within the context of existing real property and tax laws, or

Programs of direct government construction, ownership and management

The Committees of Congress agreed that the solution to the problem of producing housing for low and moderate income families lay:

First, in assisting the poor so they can afford to pay the cost of privately built dwellings, and

Second, in increasing the role of the private sector in the development of the housing by strengthening the capacity of the private organizations already involved.

Thus, Congress decided to build on the system it had developed over the years for involving private enterprise in publicly assisted housing programs. In the 1968 Act, Congress adopted programs, like Section 236, that authorize the Department of Housing and Urban Development to make mortgage interest subsidy payments on behalf of lower income families living in rental housing owned by private organizations willing to accept limited cash returns. This program increases the individual family's ability to pay rent for privately produced housing.

The Housing Act of 1968 also enacted new measures intended to facilitate home ownership on the part of low and moderate income families. The statute added several provisions to the National Housing Act permitting the sale of existing publicly assisted rental projects to tennants on a condominium basis, to tenant cooperatives, and to non-profit corporations and associations established exclusively for the purpose of owning and operating low and moderate income housing. This Congressional action reflects the serious need to encourage participation by lower income families in the management and ownership of their housing.

Congress in the 1968 Act declared that in all these new programs as well as in all existing federal housing programs ". . . there should be the fullest utilization of the resources and capabilities of private enterprise."

Tax incentives and the national housing partnership

The President's Committee on Urban Housing, a group of 18 business, labor and community leaders under the Chairmanship of Edgar F. Kaiser, was commissioned to find ways of attracting the private sector into the development of housing for low and moderate income families. The Committee recommended the creation of the National Housing Partnership as a privately funded, professionally managed instrument that would provide the equity and skills needed to produce this housing in cooperation with local developers and investors.

The Urban Housing Committee analyzed the federal housing programs for low and moderate income families and concluded that a combination of cash distribution and tax savings was essential to private participation in the production of this publicly assisted rental housing. Because the federal housing programs are designed to keep rents low, the amount of cash distribution is limited by law to 6% of the owner's equity investment, *if earned*. Federal laws oblige the sponsor of this housing to sign a contract fixing rents and requiring government approval of all rent increases. In addition, the government regulates the sale during the first 20 years of ownership, making such investments highly non-liquid and allowing little opportunity for profit from increased real estate values.

As a result of these restrictions, the Committee found that the primary incentive for private investment in publicly assisted rental housing has been the tax savings generated as a result of the book losses arising from accelerated depreciation. This tax loss can be used to offset other taxable income of a corporate owner or, in the case of a partnership, of the individual partners. The result is a savings in tax dollars varying with the taxpayer's individual tax rate.

The Committee on Urban Housing also reported that the current tax consequences of sale of such projects, particularly those providing for recapture of certain depreciation under existing Section 1250, seriously diminish the attractiveness of investment in this housing and impede efforts to facilitate purchase of projects by low or moderate income tenants or their organizations.

Consequently, in proposing the National Housing Partnership, the Urban Housing Committee emphasized that ". . . the financial feasibility of the proposal is based upon existing real estate practice and tax laws."

The Committees of Congress that reported the 1968 Housing Act also expressly recognized that the existing tax treatment of real estate, including provisions for accelerated depreciation, was essential to the financial feasibility of the National Housing Partnership and other private businesses organized to develop low and moderate income housing. The Report of the Senate Banking and Currency Committee acknowledged the importance of tax savings in attracting equity capital into housing when it authorized the creation of the National Housing Partnership in Title IX of the Act:

"This title would authorize the creation of federally chartered, privately funded corporations to mobilize private investment and the application of business skills in the job of creating low and moderate income housing in substantial volume. Such a corporation in turn would form a partnership, as its vehicle for participating in developments, projects, or undertakings for the provision of housing primarily for families of low and moderate income, pursuant to Federal programs or otherwise.

"The partnership arrangement makes it possible to assure an adequate return to investors. *Under existing Internal Revenue Service regulations and rulings*, partnership losses for tax purposes flow to the individual partners. In the case of new housing units financed on a 10-percent equity—90 percent debt basis, the annual *accelerated depreciation* of the building cost results in substantial book losses during the *initial ten years* after the project is built. Assuming the member of the partnership is in a relatively high income tax bracket, *his share of the depreciation losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capital.*" (Emphasis added.)

National corporation for housing partnerships

Pursuant to Title IX, the National Corporation for Housing Partnerships has been established. The Corporation will act as the general partner of the National Housing Partnership and will manage the day-to-day affairs of the Partnership. The limited partners in the Partnership will be corporations seeking a vehicle to invest in low and moderate income housing.

President Johnson chose 15 Incorporators with the advice and consent of the Senate to begin operations. President Nixon asked all of the original Incorporators to continue their task of organizing the Corporation and to work towards completing the initial financing.

The Incorporators have elected me Chairman of the Corporation and selected Ray Watt as President. Edgar Kaiser serves as Chairman of the Incorporators.

We have organized a small group of experts from business, housing and governments to give the Corporation an immediate staff capacity. A line of credit with 15 national banks has been arranged to meet our start-up and organizational requirements. We are currently seeking to raise $50 million of investment capital primarily to provide a portion of the equity needed to build 120,000 rental units for low and moderate income families.

Working with local sponsors, the National Partnership will organize local partnerships and invest the "risk" capital needed for these entities to develop publicly assisted rental projects. We will also provide technical assistance, processing aid, management training and other services to the local partnerships.

Consequences of Tax Reform Act on production of publicly assisted housing

We believe that the potential corporate and individual investors in the National Housing Partnership and in the local partnerships we will organize, will participate in federal housing programs only if they are able to anticipate a reasonable after-tax return comparable to that available from other investments. Yields from investments in housing are comprised of two parts—current yield earned while the project is being operated, and the ability to recover investment upon sale. Since current cash flow in publicly assisted housing is limited to six percent of equity before taxes, and since the timing and pricing of sales are regulated, the availability of adequate yields depends upon the tax treatment of accelerated depreciation and sales. The Tax Reform Act of 1969, would amend the tax treatment of accelerated depreciation and of housing sales, drastically reducing the stimulus to the production of publicly assisted rental housing.

The Tax Reform Act would amend Section 1250 of the Code to deny long-term capital gain treatment on the sale of real estate to the extent of all depreciation claimed in excess of depreciation allowable under the straight line method. Further, in the case of individuals, the Bill would treat the difference between the amount taken for accelerated depreciation and that allowable under the straight line method as an item of "tax preference income." The Bill would also allocate certain of a taxpayer's deductions to accelerated depreciation and disallow them. The combined effect of the change in Section 1250 and the other proposals is to reduce the incentive to investment in publicly assisted rental housing very seriously—particularly for the non-corporate investor. Studies undertaken for us by the accounting firm of Touche, Ross & Co. considered the effect on after-tax yields of the changes contemplated by H.R. 13270 in Section 1250, as well as the introduction of the limitation on tax preferences and allocation of deductions requirement. The studies show that after-tax yields to hypothetical individual investors in a Section 236 project could be reduced by as much as ⅓ to ½. The Touche, Ross & Co. work also demonstrates that the combined effect of amending Section 1250 and increasing the tax rate on the capital gains could reduce after-tax yields to a hypothetical corporate investor upon sale by as much as 15%.

In conventional rental housing this reduction in yields will, as others have pointed out in detail, have the effect of increasing already high rents. But in publicly assisted housing, where rents and resale are regulated, where the amounts of federal subsidies are limited and where tenants are of the most modest means, there is no way to recoup this reduction and keep investment reasonably attractive. The result is that private investment in such housing will inevitably decline below its already low level. In other words, if H.R. 13270 is passed in its present form, this nation simply will not meet its goals for low and moderate income housing.

The Corporation does not oppose the enactment alone of the limitation on tax preferences and allocation of deductions—even though they have some adverse impact on yields, particularly if sale occurs in the early years of ownership. We do oppose the amendment of Section 1250 as proposed in H.R. 13270 and point out that the adoption of the limitation on tax preferences and the allocation of deductions *as well as* the amendment of Section 1250 will seriously impair the development of decent homes for the poor. Unless a suitable and effective substitute is also intoduced, we would oppose the change in Section 1250 and the adoption of the other provisions.

Limitations on tax preferences

As indicated, the Corporation does not oppose inclusion of accelerated depreciation in the proposed limitation on tax preferences. The Corporation does oppose the proposal advanced by Secretary Kennedy in his testimony of September 4 to include as an item of preference the excess of interest, taxes and rent over receipts from unimproved real property during the period of construction. This amendment would lower yields to an individual investor in all housing, and particularly for low and moderate income units, further than is already contemplated in H.R. 13270.

Amendment of section 1250

Existing Section 1250 seriously diminishes the yield from investments in publicly assisted rental housing, and discourages sale of this housing to tenants at an early date. In both these respects, it already runs counter to objectives specifically expressed by Congress in the 1968 Housing Act. Yet, Section 521 of the Tax Reform Act would amend Section 1250 to provide for the recapture at ordinary income rates of all depreciation in excess of straight line depreciation upon the sale of the property. Such a change in the tax law would exacerbate an already difficult situation by making the tax consequences of sale of projects to or for the benefit of their tenants still harder to bear.

Consequently, we oppose Section 521 of the Bill unless a substitute measure is adopted permitting investors to sell low and moderate income housing to organizations of tenants on a basis that will allow them to recover their investments after taxes. We are prepared to offer such an alternative.

Recommendation

We suggest that the Committee implement a recommendation of the President's Committee on Urban Housing which would establish a new tax incentive that will directly and meaningfully enhance the production of publicly assisted rental housing. We suggest and we are prepared to support an additional provision in the Bill that would, in the case of an approved sale of a qualified low and moderate income housing project, forgive all tax to be paid on gain from the sale unless the gain exceeded the cost of the project as determined under Section 1012 of the Internal Revenue Code. Any gain in excess of such cost would be taxed at capital gain rates.

Under this proposal, a qualified project would be developed under the assisted housing programs of the federal government and similar state and local programs. A sale would be any sale of a qualified project for the benefit of individuals or families of low or moderate income in accordance with the regulations prescribed by the Secretary of the Treasury. In any event, governmental control of the price and timing of sales would insure that the economic benefit of this provision would inure to the acquiring low and moderate income tenants.

By reducing the tax on disposition of these projects, this provision would lower the regulated sale price of a project. The debt service requirements of the subsequent owning group would also be reduced, permitting it to set and maintain low rents. Such sales might be directed to low or moderate income families on a condominium basis, or to a cooperative formed by tenants, or to a non-profit group created for the purpose of owning this housing.

Following a sale to the tenants or to a tenant oriented organization, there will be little or no loss of Treasury revenue on account of depreciation of the project or on account of interest on the purchaser's mortgage. If the sale is made to a non-profit organization, the organization will of course not take any income tax deductions. If a sale is made to tenants themselves, or to a tenant cooperative organization, no depreciation deductions will be allowable because the use of the property by the owner is for a residence. Interest deductions will be allowable, but tenants will be in sufficiently low income tax brackets so that even if they do not elect the standard deduction, the loss of revenue will be slight.

This change in the Bill could be introduced without altering the proposed limitation on tax preferences or allocation of deductions.

The Corporation staff is prepared to discuss the details of this suggestion with the Committee staff at any time.

Before closing, let me point out two further provisions of the Tax Reform Act that we believe require technical clarification.

Hobby losses

Section 270 of the Internal Revenue Code imposes limitations on so-called "hobby losses"—individual deductions attributable to the operation or trade of a business that has produced deductions substantially in excess of gross income for a period of five consecutive years. This provision currently has no effect on the Corporation's operations.

Section 213 of the Bill would amend Section 270 to provide that, in the case of individuals, deductions:

"attributable to an activity shall be allowed only to the extent of the gross income from such activity unless such activity is carried on with a reasonable expectation of realizing a profit."

The House Committee Report states that the purpose of this amendment is to deny deductions in excess of gross income from an activity:

"where taxpayers are not carrying on a business to realize a profit, but rather are merely attempting to utilize the losses from an operation to offset their other income."

Whether an activity is being carried on with a reasonable expectation of profit will be determined, according to the Committee Report ". . . on the basis of all the facts and circumstances." The proposed amendment would create a rebuttable presumption that an activity was not being carried on with a reasonable expectation of profit if total deductions allowable with respect to that activity exceed gross income from that activity by $25,000 in three of five consecutive years.

The proposed section might be interpreted to deny to individual investors the right to use tax losses from housing investments to shelter income from other sources. Although few local investors in publicly assisted rental projects in which the Partnership participates would make investments large enough to generate sufficient losses to bring them within the statutory presumption, the Commissioner would be allowed to show the absence of a profit expectation under all facts and circumstances, without regard to the presumption.

It is our understanding that this new provision is not intended to affect real estate but is directed at certain agricultural investments. We suggest that clarifying language be added to make the section clearly inapplicable to investment in low and moderate income housing.

Limitation on interest deduction

Section 221 of the Bill amends Section 163 of the Code to limit the amount of "investment" interest that may be deducted by an individual taxpayer in any taxable year to the sum of his net investment income and $25,000. The House Committee Report states that ". . . interest on funds borrowed in connection with a trade or business would not be affected by this limitation." Rental housing, the Report continues, will be considered trade or business rather than "investment" property if the sum of the deductible business expenses of operating the property equals or exceeds 15% of rental income and the taxpayer is not guaranteed a specified return in whole or in part against loss of income.

Though Section 236 or equivalent projects will always meet these criteria, we suggest that the language be clarified to indicate that such projects would not in any case be considered "investment" property and that interest on mortgage indebtedness incurred would not be subject to the proposed limitation.

Conclusion

The National Corporation strongly supports efforts to bring equity and order into federal tax law. But, we do not understand how Congress could limit the basis for our operations when the Congress itself recognized the importance of this pattern when authorizing Title IX only a year ago. We do not understand how Congress could virtually assure that the national housing goals, which it proclaimed one year ago, will not be attained—as this is the inevitable consequence of acceptance of all of the provisions in the Bill. We do not believe that fairness and social justice are achieved by abolishing the primary means for attracting the private capital needed to produce decent, safe and sanitary housing for low and moderate income families.

Thank you for the opportunity to present the views of the National Corporation for Housing Partnerships.

The CHAIRMAN. Now, the next witness would be Mr. Brewster Ives, director and past president of Tenant-Owned Apartment Association.

STATEMENT OF BREWSTER IVES, DIRECTOR AND PAST PRESIDENT, TENANT-OWNED APARTMENTS ASSOCIATION, INC.; ACCOMPANIED BY STANLEY NITZBERG, TAX COUNSEL

Mr. IVES. Mr. Chairman, and members of this committee, may I introduce Mr. Stanley Nitzberg, who is the tax counsel for the Commerce and Industry Association of New York who is accompanying me and sitting on my left.

I appear on behalf of the Tenant-Owned Apartment Association which represents the great majority of cooperative apartment buildings and cooperative apartment owners in the metropolitan area of the city of New York. Our association was formed 40 years ago, and I have been a director of it since its inception as well as its past president.

It has been devoted to the welfare of cooperative projects and furtherance of responsible homeownership in urban areas.

I would like to depart from our formal statement, which contains the detailed analysis of section 302 relating to allocations of deductions. I have nothing to add to that technical discussion as it is beyond my personal sphere of activity. But the association and myself are primarily concerned with the problems which face cooperative apartment homeownership.

We are involved in all city problems that affect housing. For instance in one city, New York, last year, we took an active role in dealing with a fuel delivery crisis that threatened the health and welfare of our city residents. We are concerned with crime control, traffic regulations, air pollution, sanitation, noise abatement, playground as well as school facilities as these are other areas which have been of real interest to co-op homeowners and which clearly affect city residents. Our association has spearheaded many of these campaigns, and has actively participated in virtually all of them. I mention this because it demonstrates the close role that cooperative apartment ownership plays in the community welfare.

Most private cooperative ownership is through middle income and upper income families. They are in every sense of the word homeowners taking an active interest in civic affairs. Why? Because they have a very substantial stake in the community and want to protect their homes and do all they can to improve their living conditions. Because of this they become better citizens. Homeownership, including cooperative ownership, is the backbone of this country and must be encouraged. These are the responsible citizens who care about the future of our cities, and of our States and of the entire country.

The expenses incurred by a homeowner for interest and tax payments have always been deductible in computing their taxable income. This has been recognized from the beginning as an essential part of their home investment. Homeownership in our larger cities is to a great extent cooperative homeownership. There is no reason to treat cooperatives differently from one-family dwellings and, incidentally, in section 212 it is our hope that you will clarify this so that the rights of a homeowner go on and flow to cooperative apartment owners at the same time. This has always been a sacred principle of our association that cooperative owners are allowed exactly the same rights as all other homeowners. Their tax payments to local governments are equally substantial and equally important to local government activities and services. The interest charges on loans made to purchase their apartments to carry their equity are equally high and a burden to carry.

Urban centers, as you well know, are being plagued by the flight of middle and upper income wage earners to the suburbs. Those who have been able to retain their apartments in the cities have done so at substantial personal cost. Beyond the price paid for the exposure to crime and air pollution, is the out-of-pocket dollar expense of the carrying charges of cooperative apartments.

If this section further discourages cooperative apartment ownership by resulting in higher carrying charges, which it most certainly will, so that these become nondeductible either in whole or in part, it will only stimulate a new urban exodus.

We feel it is essential for a healthy city to maintain a good cross section of the population, both social and economic. My own experience in New York City, which is over 40 years, has demonstrated that an overconcentration of low-income people in any one area dooms that particular area to further disintegration. You can't get away from it.

Who are the cooperative owners today in our cities? They are a fair cross section of the urban population. They are active businessmen, they are widows, they are families that are established in the community. Among them is a concentration of many of the economic and business leaders throughout the country. They are the ones who keep our cities alive. Building after building that I can think of contains the ownership of some of the great leaders of industry and business in this Nation. Leading citizens in every walk of life.

New York City would be nothing without the island of Manhattan. By the same token, New York would be nothing without those leaders in business, who have stimulated new investment, who have stimulated new jobs, and who keep the financial community going. These people should not be attacked but should be encouraged to stay right where they are.

Cooperative homeownership means to New York, to any city, better maintained buildings. You can go up and down the avenues and into the side streets and you can see with your own eyes the buildings that are under residential rent control, and you can spot the cooperative buildings in a minute. They are all up to snuff, they are well maintained. They are properly staffed, they are well policed, properties that have become really the backbone of the city. The rental buildings are deteriorating, and you can see it with your own eyes. Cooperative buildings maintain their own security forces. We are obliged to do this because the city simply can't furnish us with the security that we need.

Today in the city of New York certainly 90 percent of the unsubsidized housing that we have is cooperative, and this has been true over the last 4 to 5 years with all new residential construction. It is a trend that should be encouraged not discouraged. New buildings in order to get off the ground have to follow the cooperative form of ownership. It is the only way we can get them built.

I only heard yesterday from another builder who said, "Tell the committee that I am not going ahead with any job,"—and it is a very big housing job—"if the tax reform bill in its present form is maintained," and this again and again has been the answer. Buildings, new residential buildings, have virtually stopped because of the mere threat of this tax bill.

Cooperative homeownership means the hope for the future survival of our cities. Let's take the case of Battery Park City which will become one of the largest, will be in fact the largest, urban development that has ever been undertaken in this country. It is the kind of development that points to the future in the the way of community planning, because there we hope to provide office buildings, apartment houses that are low income, middle income and high income, mixed together, with open spaces, playgrounds schools, churches, shopping centers. This is the kind of development that will hold essential businesses in the city. Yet the residential tenancies will have to be on a cooperative ownership basis because it is the only way they can be successfully promoted. The high- and low- and middle-income groups will be subsidizing the low-income groups, but they will be all in the same immediate area. This is a land fill project starting with the Battery and going up the North River, over 100 acres. No one is being displaced, and it will be a pattern for city living for the future because it is a city in miniature itself. It will have its own police headquarters, its own fire department. It will be a self-contained unit for working and living, and this whole project now is in jeopardy because of the provisions of this bill.

The slowdown that has occurred already has resulted in a 50 percent drop in sales of cooperatives in the last 2 months simply because the tax deduction and the interest deduction is jeopardy. It is an integral part of a cooperative owner's purchase. His carrying charges have reached the point where this is simply going to be the straw that breaks the camel's back.

It is for all these reasons, as well as those detailed in our formal statement filed with your committee, that we request that the provisions of this tax reform bill be revised.

Thank you, gentlemen, for your time.

Senator McCarthy. Thank you very much, Mr. Ives.

(Brewster Ives' prepared statement follows:)

STATEMENT OF BREWSTER IVES, DIRECTOR AND PAST PRESIDENT, TENANT-OWNED APARTMENT ASSOCIATION, INC.

SUMMARY

1. Proposed Section 302, Allocation of Deductions, is an unreasonabe attempt to limit allowable deductions because of source of payment. It will cause serious financial reverses to cooperative apartment home ownership and result in further problems for our beleaguered cities.

2. It should be made clear that proposed Section 221, Limitation on Interest, is not applicable to interest on loans taken to purchase or carry cooperative apartments and to the deduction now allowed under Section 216(a)(2), IRC.

STATEMENT

I appear on behalf of the Tenant-Owned Apartment Association, Inc., which represents 218 buildings and more than 2,200 cooperative apartment owners in the New York metropolitan area. Our Association is devoted to the welfare of cooperative projects and the furtherance of responsible home ownership in urban areas. We wish to comment on Section 302, relating to allocation of deductions, and Section 221, relating to deduction of interest.

Section 302

We do not believe that the treatment provided by Section 302 is proper. As stated in the Report of the House Committee on Ways and Means (Part 1) (at page 82) Section 302 is intended to disallow expenses on the theory, and to the extent, that they may reasonably be assumed to have been met out of tax-free income. The expenses subject to allocation are personal expenses (e.g., medical expenses, interest and real estate taxes in respect to residence) which cannot be considered as costs of earning tax-free income. Hence, a partial disallowance was thought to be appropriate because tax-free income was deemed to constitute the cash source for the payment of these expenses. Consistently with this approach, the disallowance of these expenses under Section 302 is roughly in proportion to the tax-free income.

We respectfully submit that the proposed treatment is improper for two reasons. First, it assumes that the source of payment of the personal expenses in question is solely out of income, and not to any extent out of capital. Since such expenses are not costs of earning income, taxable or otherwise, this assumption is without basis. However, even if it is assumed that the source of payment is solely out of income, this would provide no sufficient reason for disallowance of the expenses, because the source of payment of an expense is irrelevant to its deductibility. Indeed, if Section 302 were enacted, it would constitute the sole example of which we are aware in the entire Internal Revenue Code where the *source* of a payment determines its allowability as a deduction. Personal expenses of the type allocated under Section 302 are not costs of earning income, and have never bo so viewed or treated. Such expenses are allowable under the Code irrespective of their personal character. And, as stated above, the source of payment of an expense has no bearing on whether or not it should be allowed. Therefore, proposed Section 302 is without support in reason.

The disallowance of allocable personal expenses under Section 302 is related directly to the amount of the taxpayer's allowed "Tax Preferences". Thus, if the taxpayer has no allowance Tax Preferences, his personal deductions will not be allocated or partly disallowed under Section 302. No policy has been expressed in the House Report for the disallowance of personal expenses as such. Since the amount of disallowance of deductions depends on the existence and amount of allowed Tax Preferences, Section 302 represents, in substance, only a further attack on Tax Preferences. It is respectfully submitted that if a policy to disallow Tax Preferences is to be effected it should be done directly and without relation to personal expenses.

Apart from deficiencies inherent in the basic research of Section 302, as discussed above, its application to deductions arising from cooperative apartment ownership flies in the face of national concern to preserve the great cities of this nation in spite of their ever mounting problems. The enumeration of such problems here is unnecessary in view of the attention which they continue to receive by Government, and in the media and literature of our times.

The desirability of halting and reversing the seemingly irresistible flight to the suburbs of middle and high income taxpayers, one of the greatest of the problems facing the cities, is both apparent and urgent.

The proposed disallowance under Section 302 of expense otherwise allowable under Section 216 of the Internal Revenue Code, in connection with cooperative apartment ownership, would substantially aggravate this problem by adversely affecting the tax consequents of cooperative apartment ownership provided under present law. Cooperative apartment tenancy occurs almost exclusively in the cities and such apartments are owned primarily by middle and high income taxpayers. The effect of Section 302 on existing tax deductions available to cooperative apartment owners would result in substantially increased occupancy costs. This would make city living less attractive and stimulate further departures to suburbs. Certainly the continued presence of such residents in the cities, together with that of less affluent persons is highly desirable to maintain a proper balance. In view of continued concern with the urban crisis, legislation which would promote further deterioration of our cities seems most inappropriate.

Section 216 of the Internal Revenue Code of 1954 and comparable predecessor provisions have been included in the Internal Revenue Code since 1942, over 26 years. There can be little doubt that the price and value of cooperatives apartments in the market has been importantly affected by available tax alowances and that the elimination thereof in whole or in part will seriously depress such value by increasing net occupancy costs. Furthermore, the pressure caused by resulting sales of cooperative apartments would disrupt the existence of an orderly market, further depressing values. Moreover, it is contrary to our system of laws to enact legislation which would retroactively affect transactions concluded in partial reliance on predictable consequences based on then existing law.

The enactment of Section 302 will arrest the constantly growing acceptance of the cooperative form of urban home ownership. The need for providing acceptable residential accommodations for the middle and upper income segment of the urban population to insure the survival of cities is beyond question. Cooperative home ownership involves these groups in the future of urban centers and helps to preserve the stability of our cities.

Section 221. Interest

Under present law, individual taxpayers may deduct interest paid or incurred during the year without limitation on the amount of such deduction. Section 221 would limit the deduction of investment interest to $25,000 in excess of net investment income and long-term capital gains.

The Report of the House Committee on Ways and Means (Part 1) states (at page 72) that interest incurred for purposes such as "a home mortgage" would not be affected by this limitation. No express reference is made, however, with respect to interest attributable to the ownership of a cooperative apartment. To avoid problems of statutory interpretation which might be presented in the future, we believe it necessary to have an expression from this Committee that interest incurred on loans obtained to purchase or carry equity ownership of a cooperative apartment or amounts deductible under section 216(a)(2) IRC, on account of interest of a cooperative housing corporation, will be similarly treated under this provision. This treatment is consistent with that provided in Section 221 for interest on loans to acquire single family residences, and represents a continuation of the policy first expressed by Congress in 1942 that ". . . tenant stockholders of a corporative apartment (be) in the same position as the owner of a dwelling house so far as deductions for interest and taxes are concerned." S. Rept. 1631, 77th Cong. 2d Sess. (1942), at page 51.

The statutory language in Section 302 of the Bill indicates that amounts deductible under Section 216(a)(2), IRC, are not intended to be affected by Section 221 of the Bill. This is supported by the fact that new separate subsections 277(c)(1)(A)(i) and 277(c)(1)(A)(vii) are respectively provided for interest under Section 163, IRC, and amounts deductible under Section 216, IRC, including amounts deductible under Section 216(a)(2), allocable to interest of a cooperative housing corporation. The use of such separate provisions in the enumeration of items subject to allocation of deductions under Section 302 clearly indicates that the term "interest" in Section 221 was not intended by the statutory draftsmen to describe amounts deductible under Section 216(a)(2), IRC.

There can be little question that interest incurred to purchase or carry the equity in a cooperative apartment and amounts otherwise deductible under Section 216(a)(2), IRC, should not be, and are not, within the intended limitation applicable to investment interest under proposed Section 221. This should be made clear by an expression to that effect by this Committee.

The CHAIRMAN. Mr. Doughty.

STATEMENT OF WILLIAM H. DOUGHTY, PRESIDENT, NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT FUNDS; ACCOMPANIED BY H. CECIL KILPATRICK, TAX COUNSEL

Mr. DOUGHTY. Mr. Chairman, and members of the committee, my name is William H. Doughty, and I am president of the National Association of Real Estate Investment Fund. With me is our tax counsel, Mr. H. Cecil Kilpatrick.

I have no intention of reading at any length from the prepared statement already on file with you but, with your permission, and in the interests of brevity, I shall refer to a few notes that I have made from it.

The real estate trusts which are members of the association have more than 65,000 shareholders, and the object I seek here is the fair and proper handling of the taxation of those shareholders.

The provisions dealing with the taxation of such shareholders enacted in 1960 appear in sections 856 to 858 of the Internal Revenue Code.

The legislative history of the 1960 act set forth in my prepared statement makes it plain that the purpose was to permit large numbers of small investors to pool their funds in a trust investing in real estate and real estate mortgages, and that this trust would not itself be subject to income tax on distributed income, provided 90 percent or more of its income were distributed each year. The trust could thus act merely as a conduit for the income paid to its shareholders.

The committee report on that 1960 bill stated that it would extend the same type of tax treatment to the shareholders of these trusts as has been given for years to the shareholders of mutual funds under sections 851 to 855 of the Code, and I quote "Thus, this secures for the trust beneficiaries the same type of tax treatment that they would receive if they held the real estate equities and mortgages directly."

Section 452 of the bill you are now considering would appear to take away this equality of tax treatment. For example, a man of substantial means, owning business or residential property leased to tenants, would be entitled to deduct accelerated depreciation in full against rents both under the present law and under the bill as it is now written.

However, section 452 provides that a corporation using that method and getting the same rental would, in determining the amount of its earnings and profits available for dividends to its shareholders, be limited to straight-line depreciation. The result would be an increase in the taxable amount of dividend distributions.

I am not a lawyer, but our counsel has advised us that the use of the word "corporation" in the context of section 452 includes real estate investment trusts and, therefore, would result in the shareholders of these trusts being subjected to tax on greater amounts than if they held the property directly.

Since this construction of the bill would violate the legislative purpose and intent of the 1960 enactment, namely to secure for the trust beneficiaries the same type of tax treatment as if they held the real estate directly, we hope that such a construction results only from inadvertence.

Whether inadvertent or intentionally, we ask that if section 452 is retained in the bill it be amended to exclude real estate investment trusts from a class of taxable corporations subject to the rule.

At the end of my prepared statement there is a suggested form of amendment to accomplish this. Thank you, Mr. Chairman.

(William H. Doughty's prepared statement follows:)

STATEMENT OF WILLIAM H. DOUGHTY, PRESIDENT OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT FUNDS

SUMMARY

1. Under section 452, a *corporation* which uses the rapid depreciation methods (allowable under section 167(b)(2) of the Internal Revenue Code) must, for the purpose of computing its earnings and profits, deduct only straight-line depreciation. The result is that the stockholders may be taxed on distributions in excess of those which would be taxed under present law.

2. The Internal Revenue Code defines the term "corporation" as including a real estate investment trust, though such a trust is not taxed on its real estate investment trust income if it distributes 90% or more of such income to its shareholders.

3. On the other hand, an individual owner of real property is allowed to use the accelerated depreciation deductions to reduce his taxable income from the property.

4. The application of the rule of section 452 to real estate investment trusts would frustrate the legislative intent expressed when the special provisions for taxing their shareholders were enacted in 1960. The expressed purpose at that time was to secure for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate directly, by permitting pooling arrangements by small investors, in order that they might secure the benefits normally available only to those of larger resources.

5. To preserve and continue the purposes thus expressed for the enactment of the real estate investment trust provisions, the above mentioned rule as to the determination of a corporation's earnings and profits available for dividend purposes should not apply to the shareholders of such trusts.

STATEMENT

I am William H. Doughty, president of the National Association of Real Estate Investment Funds, president of Chinnock & Doughty, Chicago, and trustee of Bradley Real Estate Trust and of Chicago Real Estate Trustees. NAREIF was founded in September, 1960, with the following aims and purposes:

To broaden public understanding of the importance and value of real estate investment trusts to the American economy and the investing public,

To promote the purposes and effectiveness of these trusts by any means consistent with the public interest,

To provide a national medium for the exchange of ideas and information regarding the establishment and efficient and proper operation of such trusts,

To cooperate with and appear before governmental departments, agencies, and committees on matters affecting the industry,

To provide a national association of respresentatives of real estate investment trusts and of individuals who have a business or professional interest in such trusts,

To establish suitable liaison and cooperate with local, regional and national groups of other associations.

Members abide by a rigid code of ethics adopted by the Association.

Thirty-eight leading trusts, of both the equity and mortgage types, are members of the Association. These trusts account for the major portion of the total assets of the industry and have in excess of 65,890 shareholders who have pooled their funds for real estate investment. An additional group of 75 firms directly associated with the industry are also members of NAREIF.

My purpose in asking to appear before you is to call attention to what we believe was an inadvertent error or oversight in the drafting of section 452 of the House bill.

Under that section, a corporation which uses the rapid methods of depreciation (allowable under section 167(b)(2) of the Internal Revenue Code) must, for the purpose of computing its earnings and profits, deduct only straight-line depreciation. That is to say that, where a corporation computes its taxable income by using accelerated depreciation, its shareholders may be taxed on distributions in excess of those which would be taxed under present law.

On the other hand, an individual who owns such property would be allowed the accelerated method of depreciation to reduce his taxable income from the property.

It is the use of the term "corporation" in this section of the bill that causes us justifiable concern. That term is defined in the Internal Revenue Code in a way which includes real estate investment trusts, which we respectfully assert should not have the same rule applied to them, since this would involve a complete reversal of the policy announced by the Ways and Means Committee in reporting out H.R. 12559, which passed the House on June 29, 1960, and was added by the Senate as an amendment to H.R. 10960. H.R. 10960 was enacted as Public Law 86-779, 74 Stat. 998, approved September 14, 1960, which added sections 856-858 to the Internal Revenue Code.

The report of the Ways and Means Committee on the substantive provisions of H.R. 12559 which have now become law was House Report No. 2020, 86th Congress, 2d session. The reasons for the enactment, set forth in that report, were as follows:

"The omission of the corporate income tax in the case of distributed earnings, which present law provides for regulated investment companies, secures for investors in these companies essentially the same tax treatment as they would have received if they had invested directly in the operating companies. H.R. 12559 extends this same type of tax treatment to real estate investment trusts specializing in investments in real estate equities and mortgages as distinct from the stock and security holdings of regulated investment companies. *Thus this secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly* and, therefore, equates their treatment with that accorded investors in regulated investment companies." (Emphasis supplied.)

The Committee report further stated that this tax treatment is desirable, since this investment method constitutes "pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources" which advantages include "the spreading of the risk of loss by the greater diversification of investment * * *; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investor could not undertake singly." The intent that real estate investment trusts should be a vehicle for public and not concentrated investment in real estate is further evidenced by the requirement, in section 856 of the Code, that there be at least 100 owners of shares in order for the conduit tax treatment to apply.

That report further stated that "the real estate investment trust taxable income [i.e., income determined after allowable deductions, including depreciation] will be taxable to the beneficiaries as ordinary income."

Section 452 of the pending bill clearly would frustrate the stated purpose of the real estate investment trust provisions to "secure for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities * * * directly."

It should be pointed out, that as a part of the price for securing this conduit tax treatment for the shareholders of real estate investment trusts, which would otherwise be taxable as corporate income, the trusts are denied the following benefits of ordinary business corporations:

1. The trust may not hold any property primarily for sale to customers in the ordinary course of its trade or business.
2. At least 75% of the value of the trust's assets must be represented by real estate assets, cash and cash items, and Government securities.
3. Not more than 25% of the value of the trust's total assets may be represented by other securities; not more than 5% of such value may be represented by securities of a single issuer; and the Trust may not own more than 10% of the outstanding voting securities of such an issuer.

4. The deduction for dividends received, allowable to other corporations under section 243, is not allowed in computing the real estate investment trust income.

5. The net operating loss carryovers and carrybacks, allowed to corporations by section 172, are not allowed to real estate investment trusts.

These restrictions were imposed, in the words of the Ways and Means Committee's report, in order to "draw a sharp line between passive investments and the active operation of business."

To preserve and continue the purposes thus expressed for the enactment of sections 856-858 of the Code, it is requested that section 452 of H.R. 13270 be amended by adding thereto a paragraph reading as follows, or its equivalent in purpose and effect:

"(3) The provisions of paragraphs (1) and (2) shall not apply to real estate investment trusts, as defined in section 856."

Senator McCARTHY. Thank you very much, sir. You understand that if members have questions you will be notified and we will call upon you sometime later.

Do you have a question now Senator Bennett? If so go ahead.

Senator BENNETT. Have you dismissed the witnesses?

Senator McCARTHY. No. It is all right if you have a question.

Senator BENNETT. I have no question of these witnesses but I have a shotgun question for all the witnesses who have heretofore testified this morning: Is there any major phase of or any major effect of this bill on the real estate industry that has not been brought out by some witness or another?

Is there any witness who appeared who feels that there is something else that must be testified to that has not already been developed?

Mr. KILPATRICK. Senator, we have been asked in connection with the mortgage bankers presentation——

Senator BENNETT. Yes, I understand you are going to submit a statement.

Mr. KILPATRICK. Yes.

Mr. WOODBURY. Yes, Senator Bennett. In our written statement however, we have covered it, the question of installment sales and many technical provisions in the bill that are inadequately handled and create redundancies.

Senator BENNETT. But that information is in the testimony.

Mr. WOODBURY. Yes, it is.

Senator BENNETT. It is before the committee. Then I have no other questions, Mr. Chairman.

The CHAIRMAN. I just want to present here for the benefit of the committee and our witnesses today some indication of what our problem is with this tax bill. Here are the statements that we were favored with printed on both sides of these pages, and we have one volume of our hearings almost printed. These are the prepared statements we asked for in the hope of summarizing this testimony. Here is our explanation of the bill prepared by our staff with arguments for and against each House provision. This is the House committee report on the bill, and here are the statements that have been submitted to us.

This is the testimony presented orally and the questions asked by the witnesses before this committee which we have heard thus far and here are summaries prepared by our staff to put in a capsule what the witnesses are testifying before the committee, to summarize that before they appear.

In addition to that we have 368 pages of complexity in this bill to study which usually takes you 10 times as long to read as it does reading prose. And how many amendments do we have? And we have almost an equal number of pages of amendments and that is just the beginning of the amendments.

So when we try to expedite these hearings I hope the witnesses will understand that we are trying to meet a deadline of October 31 to report this bill. That is the reason why we have had to use every device available to us to move expeditiously and to summarize and, at the same time, try to consider the points made.

We do believe the witnesses have made a fine presentation here this morning as they have on previous occasions. I for one am going to undertake to read in detail these statements insofar as they eloborate on the points that have been made.

I yield to Senator Miller.

Senator MILLER. I was just going to comment that in addition to that one might take into account the bills, the committee reports, and the hearings reports of the legislation on the floor of the Senate which also must be voted on during this period of time by members of the committee, and then I would guess that perhaps we could add an equal sized bundle for each of the members of the Finance Committee representing the correspondence that has piled up in our baskets.

Senator CURTIS. Mr. Chairman, I would like to get into the record on that point, that it is the taxpayers I feel sorry for, and I am alarmed at what this bill will do to our economy.

Now, our good chairman here is not responsible for this. He didn't fix this deadline of October 31. The Congress of the United States is being clobbered over the head by some of its leaders to enact a bill that will have a serious impact upon our economy. Many of its provisions will bring in no income, it will be a hardship on many people and many concerns and to do it in such a short time is just not possible. And so while I am concerned about my colleagues with the amount they have to read, and I know that is true, it is the people who are going to have to live under this tax bill that I am concerned about.

The CHAIRMAN. I want the witnesses to know that in addition to Senators who generally read what is in the full statements we have two good staffs. One is the Finance Committee staff and one is the staff of the Joint Committee on Internal Revenue Taxation. Both staffs read everything that is prepared in these statements, and study the points and make sure that the best points made are pointed out to the Senators. They will both be with us when we meet in executive session, and I am going to ask that they be sure that the various points that are made here so very well are brought out before the members of the committee in executive session. So all of these points of testimony will definitely be considered.

Thank you very much, gentlemen, and members of the committee.

Did you have any questions?

Senator CURTIS. Can we question some of the witnesses?

The CHAIRMAN. By all means.

Senator BENNETT. I have no questions.

The CHAIRMAN. I asked Senators to make available to me the names of witnesses they would like to interrogate.

Senator CURTIS. I wanted to ask Mr. Newman a few questions.

The CHAIRMAN. Mr. Harry Newman. Senator Curtis wants to call Mr. Harry Newman.

Senator CURTIS. If he is not here I will pass.

The CHAIRMAN. He has retired. Let me assure Mr. Keyserling I am going to study that 110 pages prepared here. I want to thank Mr. Keyserling.

Thank you very much, gentlemen.

(Whereupon at 11:30 a.m. the hearing was recessed to reconvene Monday, September 29, 1969 at 9:30 a.m.)

TAX REFORM ACT OF 1969

MONDAY, SEPTEMBER 29, 1969

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met pursuant to recess, at 9:30 a.m., in room 2221, New Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Anderson, Byrd, Jr., of Virginia, Williams of Delaware, Curtis, Miller, and Hansen.

The CHAIRMAN. The committee will come to order.

There will be other Senators arriving at the hearings as it proceeds, and I have been advised one or two of them will not be here at this time, but they will be along as the committee conducts its hearing.

The first witness will be Senator Frank Moss of Utah. We are proud to have you today. You understand the problem, I am sure. The others will be along.

STATEMENT OF HON. FRANK E. MOSS, A U.S. SENATOR FROM THE STATE OF UTAH

Senator MOSS. I sure do, Mr. Chairman. And I appreciate the opportunity of coming and being able to lead off this morning.

I know this committee has a long and burdensome task of hearing all the witnesses who want to be heard and should be heard on this most important measure that is being considered by your committee, and I congratulate you and the committee members for your diligence.

I will stick rather closely to my text so as to conserve time.

Mr. Chairman, I appreciate the opportunity of appearing before you and our other distinguished colleagues of this committee. You have a formidable job ahead of you and I will not take very much of your time.

The burden of what I want to say is this: If we expect to stem the so-called taxpayers' revolt in this country we must do more than make token changes in our tax structure. We must come up with genuine reform, we must follow it with tax relief for the middle-and low-income taxpayer, and I think we must do it now, this session.

The House of Representatives has passed a bill which is admirable in many ways, and I commend them for their achievement, but there is still much work to be done. The House bill will serve as a vehicle for our own efforts in the Senate. It should be made the foundation for a much broader bill which I feel this committee must report and the Senate must pass.

We have patched the IRS Code up so many times, often with the intent of closing some glaring loophole, and all too often with the consequence of opening up a more expensive one, that our tax structure seems to be held together in places with little more than a string and baling wire. We have tried to assist industries in trouble, and to make it profitable and attractive to explore and develop our natural resources, and to accelerate or slow down our rate of economic growth, and we have succeeded in some respects. But we have ended up with a tax structure which is so complicated that the average person cannot understand or deal with it. While it may be a tax attorney's bread and butter, our tax structure tempts many taxpayers to spend time and money just looking for tax shelters.

The main result, however, of all this patching and tinkering is that our tax structure is no longer based on the democratic principal of strict ability to pay. It is filled with inequities. Some rich people get by without paying any taxes at all—while families on moderate incomes are so heavily taxed that they cannot keep up the payments on their homes, send their children to college, and do many of the other things that they would expect to be able to do. The tax structure has grown into a monstrosity that is both unfair, and results in gross inequality. There is a growing sense of outrage in the country—and a sense of grave injustice.

As we work toward tax reform, I suggest that we keep two overriding objectives in mind.

Our first objective should be to make the tax structure as equitable as possible. Fundamental to any system of taxation is a common belief in its fairness. Yet at the root of the long overdue "Taxpayers' Revolt" is the public realization that some wealthy persons and corporations are not paying their fair share.

Our second objective must be to provide significant tax relief for those who need it most—the moderate and lower income taxpayers. The revenue for this relief can be obtained by fulfilling our first objective—that is, plugging up the loopholes.

I shall not detain the committee by detailing the already well documented tax loopholes. Others are more expert than I on this complex subject, but I believe the Congress must do something about the following loopholes:

> (1) the untaxed appreciation of assets transferred by noncharitable gift or at death; (2) the tax-exempt status of municipal bonds; (3) hobby farming; (4) accelerated depreciations of real estate; (5) the 25-percent maximum and the 6-month holding period for capital gains; (6) the oil depletion allowance, and (7) the unlimited charitable deduction. In addition, I recommend the repeal of investment tax credit and the establishment of a minimum income tax.

The House bill, as I said, made a good beginning, but it did not plug all these loopholes. Specifically, I hope that this committee will not ignore, as did the House bill, the appreciation of assets transferred at death. The committee should also seek a better solution to the taxfree bond dilemma. As for the hobby farmer provision of the House bill, I find Senator Metcalf's proposal much more satisfactory.

I would like also to comment on some of the changes the Nixon administration has recommended. The President, I am afraid, has remembered those who financed his campaign rather than his rhetoric about the forgotten man. Mr. Nixon's forgotten millionaires will appreciate and probably remember his efforts to emasculate the minimum income tax provision. By removing income from tax-exempt bonds and the appreciation on charitable donations from the limited tax preference category, the Nixon administration would continue to make it easy for some millionaires to pay little or no taxes. Not only does the President seek to preserve the tax-free bond loophole, but he will not even let the minimum income tax provision catch just half of the privileged income of those individuals who are obviously exploiting this loophole. One cannot help but suspect that the Attorney General's influence extends even to tax legislation.

Mr. Nixon's forgotten American was even more forgotten when the administration recommended cutting the average taxpayer's relief by $1.7 billion and turning $1.6 billion of it over to corporations in the form of a 2-percent reduction in the corporate tax rates.

After ramming through a 10-percent surtax, it seems inexcusable to me that President Nixon should want to take away half of the tax relief which the House bill promised the average taxpayer.

I believe that if the Congress attacks the major loopholes with vigor, we can increase Treasury revenues by at least $8 billion. But this money should be transformed into tax relief for the average taxpayer. I will not squabble over the specific form that this relief takes—but I am determined that the reliefs be directed to the middle and lower income wage earning taxpayer.

And finally, I suggest, that in making our reforms we keep our eyes open for ways to simplify the filing of tax reforms. The present system is so complex that even taxpayers of modest means—people who are living on retirement income, as an example, must pay a tax attorney or an accountant to get help in filling out their comparatively meager returns. This is indefensible.

Mr. Chairman, if we don't succeed in achieving genuine tax reform—if we don't require rich people to pay their share of the tax burden, and if we don't relieve the middle income citizen who has had his backbone bent by taxes for far too long, I think we may have a tax mutiny on our hands in this country.

Although the lobbies are active in opposing some of the reforms which the House passed, and some which have been suggested for consideration by the Senate, I think many of them have seen the handwriting on the wall, and they know that the time for change has come. Our people are clamoring for reform, as they have never been before, at least in my time. The Senate is in the mood for genuine tax reform. I think we can pass a bill which does an effective and far-reaching job.

We have the best opportunity since I came to the Senate to make some really effective changes in our tax structure.

We have an opportunity to return our tax system to the principle on which it was based—the principle of ability to pay. So I say let us seize this opportunity now.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Moss. If it is all right with the committee, we will continue under the same rules we were proceeding last Friday. If the Senator wants to ask one question, he can ask one, otherwise I will call the witness back.

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Senator CURTIS. Do you favor the House bill?

Senator MOSS. Not in its entirety but I think it is a good beginning. It has very good features in it and I think with a few refinements some of which I tried to suggest in very broad outline that the Senate could take the House bill and make it into an excellent tax bill.

Senator CURTIS. Would you elaborate on that, not now but for the record, if you will elaborate on that for the record.

Senator MOSS. I will be glad to.

Senator CURTIS. Get it back to us.

Senator MOSS. And submit it in writing; yes, sir.

(The committee subsequently received the following additional statement from Senator Moss.)

It would not be possible for me to comment on all the many provisions of the House tax reform bill, so I will mention only some of its major inadequacies:

First. I believe that the House bill should be amended to include a tax at capital gains rates on the appreciation in assets transferred at death. Such a tax should not apply to transfers to charities, to transfers between spouses, nor to estates valued less than $60,000.

Second. The House bill provision concerning tax-free bonds does not seem satisfactory to anyone. In my colloquy with Senator Hansen I offered three suggestions. But let me emphasize, that unless and until a substitute means of assisting local governments with their borrowing costs is instituted, I would not favor removing the tax-free status of municipal bonds.

Third. I oppose the hobby farmer provisions of the House bill. Senator Metcalf's solution is a much better one. His bill would limit to $15,000 or to the amount of "special deductions" (listed in the bill), whichever is higher, the amount by which a "farm loss" may offset nonfarm income. "Special deductions" are those that are clearly beyond the taxpayer's control—fire, storm or other casualty, losses and expenses from drought, taxes, interest, theft of farm property, and recognized losses from sales, exchanges and involuntary conversions of farm property. Neither the House-passed bill nor the Administrations' proposal contain comparable provisions to protect legitimate farmers from being penalized for having incurred an economic loss in a given year.

Fourth. I oppose the 7½% tax on foundation income. I believe we must and can prevent the abuses of the tax exempt privilege by some foundations, but I see no reason to punish all foundations. The revenue gain is minimal compared with the good works that would be left undone.

Fifth. I would include under the limited tax preference provision all forms of income with exclusion. In order to have a true minimum income tax, we cannot allow any escape hatches from paying income tax on at least 50% of an individual's income.

Senator HANSEN. Let me compliment you on your statement.

First of all let me say I am sure you are aware, Senator Moss, that the national Governors' conference has gone on record as being 100 percent opposed to the changing of the tax-free status of State and municipal bonds, and yet, as I understand your statement, you favor taxing these bonds. Do I infer from this that you and Governor Rampton are on opposite sides of this argument in the State of Utah?

Senator MOSS. I don't think we are on opposite sides, although I admit we have a difference of opinion on the matter, which I have discussed with the Governor at some length.

As I see this tax-free municipal bond situation, there are two factors to it: One is enabling the municipalities and the lower governmental units to obtain the capital funds they need at a reasonable cost—a lower cost than they could obtain on the open market without the tax-free status.

The second is the fact that we have a number of our people, and they generally tend to be the wealthy people, that by buying enough of those bonds end up paying little or no income tax.

But before we can correct the inequities caused by the tax-free status of municipal bonds, we must create a satisfactory mechanism for assisting local governments in meeting their borrowing cost. I have suggested three possibilities, and there may be more.

One is to set up what might be called an urban bank or some such name as that, where they could borrow the money from a Federal lending institution at a fixed interest rate.

Senator HANSEN. Who would subsidize that rate?

Senator MOSS. It would be the Federal Government.

Senator HANSEN. Who is that, all taxpayers?

Senator MOSS. All taxpayers; that is right, because this is coming again into tax equality.

Second, I think a regular pattern of subsidization by the Federal Government of the difference between a low fixed interest rate and that rate they would have to pay in the open bond market to take care of times like this of high interest rates would be equitable. This is desirable because the whole pattern of Federal financing now is to try to get money back into the smaller governmental units. I think that this can be done, at some expense to the Treasury, that is true, but it would remedy one of the great inequities, and that is having people with a large amount of money put it into tax-exempt bonds with the result they have an income which can be toted up at the end of the year on which they owe no tax at all.

They probably don't draw as much percentagewise on their money as they might have in the stock market, but nevertheless they still have large incomes on which their tax is totally excused, and this is the place where I think the inequity creeps up.

Senator HANSEN. Excuse me.

Senator MOSS. I just wanted to add one factor. I know there has been a discussion as to the exact amount of the tax leak. I may not have authoritative figures, but I have been given to understand that the advantage that the lower governmental units get in selling their bonds at a lower price is more than offset by the revenue loss that the Federal Treasury suffers.

A third possibility would be to have the Federal Reserve purchase local government bonds, but at a low interest rate.

Senator HANSEN. I realize my time has passed, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator MOSS. Thank you.

The CHAIRMAN. Incidentally, if Senators want to they can prepare written questions to submit to witnesses when they are through, and at the request of any Senator we will ask any witness to come back for interrogation after we have heard all witnesses. Thank you very much, Senator Moss.

Senator MOSS. Thank you.

The CHAIRMAN. The next witness is the former Governor of Texas, the Honorable John B. Connally on behalf of the Livestock Producers Committee.

We are certainly happy to have you here with us today, Governor Connally. Being from the neighboring State of Louisiana I know you served more than once as Governor of Texas.

STATEMENT OF HON. JOHN B. CONNALLY, ON BEHALF OF THE LIVESTOCK PRODUCERS ASSOCIATION

Mr. CONNALLY. I want to extend to you my deepest thanks for the opportunity to appear here today and, if I may, I would like to present most of my testimony in a standing position, and also would like to use a few charts to put into perspective the problem about which we speak when we talk about the farm and ranch situation and farm losses in the United States.

I want to first point out that in the past——

The CHAIRMAN. If you would care to have it that way, Governor, you can put this chart right over here where the audience can see it as well as all members of the committee.

Mr. CONNALLY. Within the time allocated to me, Mr. Chairman, it is obvious I cannot even begin to go into the real economic situation regarding the agricultural pursuits of this Nation but I do have a few charts that I think in themselves will somewhat briefly explain the situation.

We have shown on this first chart food expenditures in relation to income. The green line reflects the disposable personal income in the United States on a per capita basis from 1965 to 1969.

You will see the trend of the disposable income is up. The red line reflects the food expenditures on a per capita basis. This trend is downward which is good, and the difference between the two is constantly becoming greater.

On the bottom chart, during this same period of time, is reflected the cost of food as a percentage of income, and it is down from about 18 percent in 1965 to 16 percent today. Food expenditures in the United States represent only 16 percent of the disposable income of the American people. This is the lowest in the history of the United States, the lowest of any civilized nation in the history of the world.

One other important factor in talking about farm and ranch incomes, and the tax measures respecting those who pursue agriculture in this country, is shown by the prices paid for necessary purchases, and prices received by farmers and ranchers for commodities they sell; keeping in mind that ranching is one segment of our society that basically operates in a free market.

This again takes the period from 1950 to 1969. The green line reflects the prices received by farmers and ranchers for the commodities which they produce. The red line reflects what farmers and ranchers paid for the items which they purchased, and may I at this point say to you that agriculture is today the biggest business in the United States of America. Four out of every 10 jobs in the United States are either directly or indirectly related to agriculture.

For instance, farmers and ranchers are the largest consumers of petroleum products in the United States of America. Last year their purchases of rubber alone were sufficient to put tires on 6 million automobiles. They spent $51 billion for fertilizer last year. I will have some other statistics to give you in just a moment.

The net effect is that only in the period from about 1951 when we saw livestock prices at an all-time high, to about 1954, farmers and ranchers were receiving more for their commodities than they paid for their purchases; but since about 1959 the trend has been just the reverse.

Now, when you talk about cattle in particular, and this is the thrust of most of the provisions with respect to the tax bill as passed by the House of Representatives, H.R. 13270, this next chart shows the average annual price received by Texas producers for calves, and this is basically what they sell.

Again you will recall in 1951, farmers received approximately 30 cents per hundredweight for their feeder calves. This is the highest price in modern history. But in spite of all of the talk of the housewives about high food prices in this Nation, it is significant that in the succeeding 18 years prices received by ranchers for their calves have never reached the point that it did in 1951. It has increased a little bit here during this year, and this chart reflects that uptrend, because this chart was prepared on the basis of prices received during approximaely the first 6 months of this year. It is significant that in June the prices were going up. Since June, the prices have dropped 20 percent, already this year.

So the significance of this chart simply shows that in 18 years the prices received by ranchers for their calves has never reached the point that it did in 1951, which again bears out that the biggest bargain in the American economy today is beef so far as the prices received by the producer is concerned. Referring back to the first chart, this is further borne out by the fact that only 16 percent of the disposable income in the United States today is expended for food.

Here is an equally significant chart. When we talk about those who go into farming and ranching, this chart clearly shows the personal income of the farm population. Now, admittedly the farm population is decreasing in this country, it has every year for many, many years since the beginning of World War II and, in my judgment, it is going to continue to decrease.

It is significant that today approximately 5 percent of the American people feed themselves and the other 95 percent. There are only approximately 5 percent of the people of the United States directly engaged in agriculture. This again is the lowest figure of any civilized country on the face of the earth, lower than it has ever been in all our long history.

The red portion of this chart shows the personal income from farm sources. The green portion of the chart shows the ascending line and trend of income of the farm population from nonfarm sources.

Senator CURTIS. Mr. Chairman, may I ask a brief question for clarification. That is based on a farm unit, where the husband is farming and maybe the wife is teaching school or holding a town job?

Mr. CONNALLY. Yes, sir; that is it.

Speaking of the average farm family today, the farmer is 51.3 years of age, he has a family of 3.6 in the family. This represents the entire farm family income.

But it is clearly shown here, the trend of nonfarm income is on the ascendency.

Forty-six percent of all of the farm population of this Nation receive nonfarm income, or income from outside sources; 32 percent of all of the farm population of this country receive income from over 100 days a year of nonfarm work. Now this becomes significant because we are talking about what we can do, what can be done, to get at those few people who take advantage of or abuse the tax laws with respect to farming and ranching.

Now, there are certain significant things that I think all of these charts lead us to and that is simply there is no question in my mind but what if we are going to continue to have the type of agricultural business that we have had throughout the history of this Nation, if we expect 5 percent of the people to produce the food and fiber for 100 percent of the people, then we are going to have to have constantly an infusion of new capital into farming and ranching.

I am concerned by some of the comments made before this committee and before the House Ways and Means Committee with respect to abuses. I obviously can't cover every facet of the proposed bill or all of the testimony which has been given, but let me address myself to two or three things.

First, people are continually talking about "hobby" farming and I submit to you, Mr. Chairman, and members of this committee, there is no such thing as a "hobby farmer." This is a misnomer and a misconception and a contradiction in itself. There is no such thing as a hobby farmer in this country because the present laws prohibit it. Section 162 of the code itself, and Treasury regulation 1.62–12 prohibit it. They say, in effect, in the legitimate sense you have to operate a farm and ranch for a profit, not for pleasure. The courts have so held. I am not talking about section 270, where you have to make a profit once every 5 years. That is a separate thing.

There are two basic tests as to the legitimacy of a farmer and rancher in America today. One is a subjective test arising of section 162 of the code. The other is an objective test contained in section 270. The subjective test I say to you is a meaningful test if properly applied by the Internal Revenue Service; two-thirds of all the cases taken by the Government to the Tax Court have been won by the Government in dealing with the subjective test of section 162. You don't have to operate 5 years before IRS can throw your expenditures into question. Section 162 simply provides that they can question you and look at you every year, and if you do not operate for profit, can disallow your losses.

I was struck by Senator Metcalf's testimony here last week, when the committee was so overburdened they couldn't hear us all, and I again want to express my gratitude for the opportunity of being here today. He was talking about an individual whose name is in the record so I don't mind using it, Mr. Stevens, who bought a ranch in his home State. The Senator alleges that Mr. Stevens charges off hunting and chain link fences as a ranch expense, and so forth. I haven't seen the man's tax return. I doubt that he does it, but if he does try it, I sure doubt that the Internal Revenue Service allows it, because they don't have to allow it under the present law. As a matter of fact, I would make the assertion that they don't allow it under existing law; and I know of a number of cases where they don't.

Any time they determine that a farm or ranch is being operated as pleasure and not for profit they can disallow all of the expenses with respect to that operation under existing law.

The Chairman. We'll just get that tax return and find out who is right and who is wrong about it.

Mr. Connally. All right, sir.

Second, some allegations have been made by various witnesses before this committee that we need to reform the tax laws with respect to farming and ranching. It has been said that we need EDA, we need allocations of deductions, we need limited tax preference, we need to change section 270, in order to drive the price of land down. Well, I submit to you that there are only three times that anybody who owns land ever wants to drive the price of land down: First, when he is buying land, he wants to buy it as cheaply as he can. Second, when the Board of Equalization meets to establish an ad valorem tax value, he is not too interested in land prices being high. The third is when he dies, the estate wants to get as cheap a price on the land as possible. But these are the only times in a man's life when he ever wants cheap land prices.

I submit to you if you ever break the price of land in this country you place in jeopardy every rural community in the United States, and every taxing body depending upon the value of the land. This includes every independent school district. I submit to you gentlemen, that the whole policy of this country has been to try to foster a return to the ranch and to the farm, to keep people out of the urban centers, to try to make it attractive to live on the farms and ranches, and I think that should be considered when this committee, this distinguished group, considers the tax laws of the country.

I submit to you finally, and I know, Mr. Chairman, my time is limited, there are provisions in the House bill that, in my judgment, would cure whatever abuses presently exist today.

Number 1, they have suggested that you prohibit the exchange of bull calves for heifer calves.

Number 2, they suggest that the holding period for breeding stock be increased. I personally don't think we ought to. I think it is unfair to require them to be held any longer than they are today. But the National Livestock Tax Committee accepts it and I would not vigorously oppose it.

Third, they recommend that there be a recapture of depreciation on breeding stock, and with this I agree.

Fourth, they recommend that in the sale of land that you recapture certain expenditures such as, for soil and water conservation, land clearing practices, et cetera; if the expenditures were made within 5 years preceding the sale.

I submit to you that these provisions will knock out substantially all of those who would attempt to use the tax laws of this country, not for the purpose of entering into farming and ranching on a legitimate and profitable basis, but rather to do it as a pure tax dodge. Thank you very much, Mr. Chairman, gentlemen.

The CHAIRMAN. Thank you very much.

Thank you very much, Governor Connally.

Senator CURTIS. Mr. Chairman, may I just observe that I want to congratulate you on your very forceful statement. It is sound, it has no answer. I hope that your testimony will be compulsory reading for everybody in government, including the Consumers' Council, and while I am going to resist as long as I can the time when we will appoint a Democratic Secretary of Agriculture but when that time happens you are my candidate. [Laughter.]

Mr. CONNALLY. Thank you very much, Senator Curtis. I am not sure you are my friend. [Laughter.]

Mr. CONNALLY. But I appreciate your sentiments.

The CHAIRMAN. Thank you very much, Governor.

As you know, we are trying to move on with the hearings otherwise I would like to interrogate you at some length about it, but I promise to read your entire statement.

(Gov. John B. Connally's prepared statement follows:)

STATEMENT OF JOHN B. CONNALLY, HOUSTON, TEX., ON BEHALF OF THE LIVESTOCK PRODUCERS COMMITTEE

I. INTRODUCTION

My name is John B. Connally of Houston, Texas, where I practice law. I am appearing here on behalf of the Livestock Producers Committee, a group of approximately 50 farmers and ranchers in the Southwestern United States. I should add, however, that since I was raised on a farm and have owned farms and ranches in Southwest Texas since 1951, I am also appearing on my own behalf.

II. CURRENT ECONOMIC SITUATION IN FARMING AND RANCHING

Many of you are familiar with the deplorable economic situation of the farmer and rancher in the United States. Nevertheless that economic situation should be outlined and illustrated as a backdrop to an examination here of some of the provisions of "The Tax Reform Act of 1969" with respect to agriculture.

One of the witnesses before the Ways and Means Committee in the hearings on this bill referred to the "tragic cost-price squeeze" on those engaged in American agriculture. I could not agree more; we have a crisis arising from the costs of the farmer-rancher rising faster than the proceeds from his production. For all of this century those in the agricultural business have bought in a seller's market and sold in a buyer's market.

This "squeeze" is illustrated graphically by Chart 1. You will note that since 1950, the earliest year shown, the major costs of producing livestock have risen steadily but the retail price of livestock, particularly beef, has risen only slightly. Now only 16% of the consumer's disposable income, the lowest percent in modern history, is spent on food, which is the greatest bargain in the American marketplace.

A rancher has been able to absorb these spiraling production costs without comaparable meat price increases only by cutting his profit margin to the vanishing point. For example, to obtain an economic profit of $3,100 in the cattle business today, a recent Texas A&M University study concluded that an investment of $112,000 was needed, a return of less than 3%. Even that return is inflated because *it does not include anything for the rancher's labor or overhead.* If the rancher paid himself just the minimum wage, his "profit" from this $112,000 investment would vanish, to be replaced by a loss.

In spite of this bleak economic picture, obviously the livestock industry has survived, and continually developed better quality products, without receiving any of the approximately 3 billion dollars in direct annual payments that the United States Government has made under the crop price support programs.[1]

This remarkable result has been achieved partly through the dedication to a way of life of those living on farms and ranches, demonstrated as a heritage of their forebearers, but perhaps more importantly, it has come from a continual infusion of new capital from the other segments of the American economy. That new capital is evidenced by the increasing amount of nonfarm income that is earned by farmers and ranchers. Some of that money comes from the earnings of those who have lived on a farm or ranch all of their lives, but more of it at the present time comes from those who live part time in urban communities but desire to return or begin to spend time and money in the rural community. These are the people who are experimenting with the new types of livestock that give more eatable beef per animal than ever before, who produce more calves per mother cow than ever before and who bring that calf to market at a greater weight; these are the people who are developing the new grasses and weed killers; these are the people who have spent the enormous sums necessary for soil conservation and to restore the water level.

[1] Although there is a meat import quota, the quota level has never been invoked.

The need for outside capital

As much as we would like to think of agriculture as being a self-supporting, self-perpetuating industry, the data demonstrates that capital outside of agriculture is a necessity for its survival. Agriculture, in fact, requires great quantities of new capital, usually far beyond the quantity commonly available to the typical farm or ranch producer. This is particularly true when we look at the capital requirements to build up cattle breeding herds and similar livestock ventures. Not only do the animals themselves require a tremendous maintenance cost, but for the first year or two and maybe even three, they must be maintained with no basic return to the herd. Some individuals, of course, purchased mature breeding stock but most herds are started with young heifers or even calves born on the place. Regardless of the acquisition age the incidents of nonfertility, disease problems, and wrong types of animals often requires heavy culling during the first few years of a breeding herd development. Revenues during this period are extremely low and the results frequently lead to unprofitable operations for several years.

In a recent publication from Purdue University the author made the following statements regarding capital availability: [2]

"Financing and capital availability has played an important part in the development of the beef industry. The quantity and availability of capital has influenced the development and production of feeder cattle, cattle feeding, processing, and the distribution of beef to varying degrees almost since the establishment of the industry.

"This willingness and ability of outside financing to invest in the various aspects of producing cattle and feeding them had undoubtedly been a factor contributing to the continued expansion of the industry during recent years. . . .

"Cattle feeding certainly could not have progressed to the point it has in terms of size and scale of operation without the availability of large amounts of capital. . . . Investments totaling several millions of dollars in both fixed and operating capital are not uncommon for these operations."

Outside capital flowing into agriculture has resulted in improved land, developed new breeding stock, refined technological developments, and has paid for public and private agricultural research.

Beyond this, as General Rudder will discuss more fully, it has also been responsible for thousands of demonstration farms at the local county level. The entire concept of demonstrations, which are usually handled by the local county agricultural agents, depend upon the ability of the agricultural producer to withstand the additional costs involved in adjusting his production, maintaining additional records, and encompassing additional cost expenditures, to demonstrate a new technological development or new technique to his neighbors.

It must be recognized that much of the land clearing, brush removal, stock pond building and improved pasture development which has occurred in the United States in the livestock production areas has, in fact, been accomplished by the larger producer. The real issue at stake is whether or not this individual will continue to improve the agricultural productivity of the Nation's farmlands, if he is discouraged by the Federal Tax laws.

The battle against brush is a continuing one, and it is one in which, even for all the monies which have been expended, we seem to be losing. Massive water development plans for the Southwestern part of the United States can, in fact, transform these arid regions into virtual productive gardens. In the meantime, however, such areas, of the country must depend upon the private and personal sector of the economy to provide stock ponds for livestock and privately financed irrigation projects in order to maintain the productivity of the area. All this can be placed in jeopardy and good sound range management conservation measures abandoned if the present tax laws are changed (except for the provisions suggested herein).

The tremendous investment involved in land improvements is emphasized in the *Journal of Farm Economics* by Philip M. Raup.[3]

"In accounting for recent land-value increases it is also appropriate to examine recent investments made in land and consequent improvements in the quality of the land input. One of the most prominent investments in quality improvements

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[2] Jack Armstrong, "Cattle and Beef Buying, Selling and Pricing Handbook," Purdue University, May 1968.

[3] Philip M. Raup, "Land Values and Agricultural Income: A Paradox?" *Journal of Farm Economics*, December 1965.

has been soil conservation, including structures, land-protective measures, and tillage practices. Another prominent investment in land has resulted from rural electrification, improved water supply, and water distribution and storage systems.

"Between 1932 and 1959 a total of 7 billion dollars was spent for conservation purposes in the U.S. Some part of this, and perhaps the major part, has had long-run effects on the quality of the land factor, and should be reflected in higher values."

Frequently, it is these farmers and ranchers with substantial outside capital who have been the major supporters of agricultural research at the Experiment Station in land grant universities through private research fund donations. A study performed in California and reported in the *Journal of Farm Economics* indicates that not only has the financial support of such groups and individuals been quite substantial but that the time lag between the initial project instigation and the actual accomplishment of the technological advancement has been shortened considerably through the use of these additional funds.

Probably no one statement has best expressed the real needs for increased capital in agriculture than that made by Mr. Gene L. Swackhamer with the Federal Reserve Bank of Kansas City.[4]

"The change in agriculture that we now perceive is not a sudden development—only our attention has made it seem so. Small-unit agriculture was the dominant feature of our agrarian past. The family farm was cherished and protected because it represented the very best that our democratic society could offer to man. The farmer was laborer, manager, and generally, land-and-capital owner all in one. At his best, he was an entrepreneur in the truest sense.

". . . Yet, almost from the day the first fence went up in the prairie, agriculture was undergoing change.

". . . Land, labor, and capital are still agriculture's principal resources, and the farmer is still the entrepreneur masterminding their productive combination. Yet, the mix of resources is ever changing and the entrepreneural role of the farmer is much changed from the nearly self-sufficient status of pioneer farmers.

". . . In addition to changes in farm size, the land tenure pattern of farming has moved toward part ownership. As reported by M. L. Upchurch, Administrator of the USDA's Economic Research Service, only 7 per cent of full owners had farms with sales of $20,000 or more in 1964, compared with 24 per cent of the part owners and 16 per cent of tenants.[5]

". . . Capital has become agriculture's fastest growing productive resource. This, too, can be seen in Chart 1. The use of purchased nonfarm resources such as machinery, equipment and production items has increased the need for agricultural credit. The use of credit in agriculture has been expanded rapidly since 1950, while the total farm economy has been growing at a more modest rate. Cash receipts from farm marketings have increased at a 2.5 per cent average annual rate, compared with non real estate farm debt which has increased at an average annual rate of 8.6 per cent. The average annual increase in realized net form income since 1950, however, has been only about .8 per cent—reflecting increasing input prices relative to product prices, and the use of a higher proportion of purchased inputs. Clearly, accumulating sufficient capital for efficient farming is a problem—implying that the need for farm credit will continue to be extensive.

Another aspect increasing the capital requirements for maintaining a large beef breeding herd is the growing size of the market. Today the United States has become a major exporter of beef breeding cattle. During the year 1968, exports of beef breeding cattle reached an all time high of slightly over 20,000 head. This represented an increase of 17% over the 1967 level. Most of this increase was due to increased exports to Chile and Canada, although Mexico continues to be the leading export outlet for U. S. beef breeding stock. Venezuela ranks as the second most important market with Canada third, and Chile fourth.

Other countries which purchase substantial numbers of U. S. beef breeding cattle are Guatemala, Costa Rica, Ecuador, Brazil, Panama, Republic of South Africa and the Philippine Islands.

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[4] Gene L. Swackhamer, "Growth of Corporate Farming." Statement before the Colorado Feeder's Association, February 8, 1968.

[5] M. L. Upchurch, "Farming and the Rural Scene—Changes in Organization, Opportunities and Problems." A talk presented at the 45th Annual Agricultural Outlook Conference, Washington, D.C., November 14, 1967.

The Hereford breed led all others numerically in 1968, but the Brahman breed ranked second in importance. It is interesting to note that high on the list of breeds of cows exported are the American developed breeds of Santa Gertrudis, Beefmaster, Brangus, Charbray and Braeford as well as various other cross-breds that were not identifiable as to breed.

The exportations of beef breeding cattle requires tremendous capital. This capital is utilized in advertising, contracting, litigation, foreign trips and numerous merchandising techniques required to conclude such sales. Such foreign sales cannot be undertaken by individuals with limited capital. The beef breeder who desires to enter this foreign market must have the financial resources to withstand all the normal market development costs involved.

The leading State in the United States for the exportation of beef breeding cattle is Texas. Not only does Texas account for well over one-third of all the beef breeding cattle exported from the United States but it, together with Florida, accounts for almost 60% of the total of such exports. Two-thirds of all the exports of beef breeding cattle in the United States are from the States of Texas, Florida, Arizona, New Mexico and California.

The Ports of Houston and Galveston are the major points of debarkation for the United States exportation for beef breeding cattle, particularly those destined for Latin America countries.

The exportation of beef breeding cattle represents a rare event to the agricultural field; it is one of the few livestock commodities that is exported from the United States, and one of the even more rare commodities that is exported for cash, and not under a government subsidized program. Such exportations, therefore, accomplish numerous goals: (1) they gain foreign exchange for the United States; (2) they provide higher quality animals to foreign countries which, in turn, can be utilized to upgrade their own domestic herds, and (3) they offer the seed of a new commodity—beef—which can be used to raise the standard of living in these underdeveloped countries.

The magnitude of agriculture's economic impact upon the supplying industries is tremendous, and can be best illustrated by the following passage which is taken from the introduction in the *Yearbook of Agriculture*, 1968:[6]

"In the mid-1960's, farmers were spending annually about 3.4 billion dollars for new farm tractors and other motor vehicles, machinery, and equipment—providing jobs for 120,000 employees.

"They annually purchased products containing about 5 million tons of steel and 320 million pounds of rubber—enough to put tires on nearly 6 million automobiles.

"They use more petroleum than any other single industry—and more electricity than all the people in industries in Chicago, Detroit, Boston, Baltimore, Houston, and Washington, D.C. combined."

It has been noted by the U.D.A. that the innovators of the agricultural community are also the principal purchasers of farm real estate. So too are these larger more progressive producers, the big users of the latest technology, the newest equipment, the larger quantities of fertilizer, and also the experimenters of new breeds, techniques and production methodology.

As the price of labor increases because of higher wage rates, agricultural producers are moving toward more labor-saving devices. The result is an increased reliance upon more capital expenditures for such equipment. This concept of increasing capital requirements as labor requirements decrease on the farm is examined by an agricultural economist in the *Journal of Farm Economics:*[7]

Is it possible that withdrawal of labor has forced the producer's attention to labor-saving techniques and to equipment that can be used effectively only with relatively large acreages? As labor becomes scarce and increases in value, operators shift to capital substitutes that can enjoy economies of scale over lower ranges of input. The tractor, for example, permits substantial economies of scale up to a given level of rate of use per year. To put it to work requires more land. Greater efficiency can be achieved by adding more acres, and part of this economic advantage can be bid into the price of land needed to bring unit cost down. This can lead to an active demand for land, associated with withdrawal of labor. It is possible to conclude that a withdrawal of labor con-

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[6] Orville L. Freeman, "Science for Better Living," *Yearbook of Agriculture*, U.S. Department of Agriculture, 1968.

[7] Raup, op. cit. note 3.

tributes to an increase in the price of land or creates offsetting forces that keep the value of land from falling relative to labor.

"A great man once wrote:

" 'No man is an island, entire of itself; every man is a piece of the continent, a part of the main; . . . ' ".[8]

I most respectfully say to you that agriculture is not an "island" unto itself that can or should be blocked off from the infusions of capital so necessary to it; it is a "part of the main" stream of progressive America.

Let us be honest with outselves. A small ranch can no longer support a family. No return of less than 3% or a loss is going to attract new capital so desperately needed. The farmers and ranchers need a continuation of most of the present provisions of the Internal Revenue Code in the manner I shall indicate.

III. THE FARM LOSS PROBLEM

I do not say that the provisions of the Internal Revenue Code with respect to farming and ranching should be left as they are. As is so often the case, over the years practices develop that are in essence abuses of the spirit of the Internal Revenue Code and the regulations thereunder. This is true in every area of tax law.

Now in the last few years it has become apparent that some people have gone into the livestock industry solely, or primarily, for the tax advantage. Neither the Livestock Producers Committee, nor any other person that knows the agricultural industry defends these "abuses." So far as I can tell there is no person appearing before this Committee that defends that taxpayer who has been called a "Wall Street cowboy."

Today I speak only for the farmers and ranchers who are engaged in the agricultural business for an economic profit. Naturally there is a problem in distinguishing the legitimate farmer-rancher from those who seek only a "tax profit." As indicated above with respect to capital needs, the fact of nonfarm work or income is not an appropriate test. Leaving aside capital requirements, practicality requires a recognition of the fact that, according to the latest census figures, 46% of all farmers and ranchers in the United States reported some days of work off their farms and 32% reported such work amounted to 100 days or more. The importance of non-farm work can be judged from the fact that last year it provided well over half of the total income of those farmers with less than $10,000 in farm sales. Even the farmer whose farm sales exceeded $40,000 derived 17% of his income as the result of non-farm work.

These figures demonstrate that whether you are large or small the rancher or farmer has "outside" income in an increasing amount.

In addition, legitimate farmers and ranchers cannot be separated from the "tax profit" investor by the amount of non-farm income test as proposed in essence in H.R. 13270 or by other bill before this Committee. In justification of such test the Ways and Means Committee Report stated that as a taxpayer's adjusted gross income increased, the average size of his loss also increased. This is only to be expected in a normal business operation. All other things being equal, if there is to be a loss, a large business probably in a risk operation will lose more actual dollars than its smaller counterpart.

Yet it is important to note that the same statistics show that the losses represented a smaller percentage of adjusted gross income as the size of the enterprise increased. I have here a chart which illustrates this (Chart No. 2). For example, farmers and ranchers with adjusted gross incomes of less than $15 thousand had an average net farm loss of over 22% of their adjusted gross incomes. Farmers and ranchers whose adjusted gross incomes were in excess of $100 thousand had net farm losses amounting to about 6% of their adjusted gross incomes.

IV. STATUTORY CHANGES CONGRESS SHOULD ADOPT

There are certain concrete steps that can be taken by Congress to prevent the "tax profit investor" from utilizing the present law (or at least one interpretation thereof). The Livestock Producers Committee urges your approval of four provisions of H.R. 13270. These are:

1. Extension of the recapture of depreciation provisions to breeding animals.
2. An increase in the holding period for which breeding animals must be held in order to obtain capital gains treatment on their sale.

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[8] John Donne, "Devotions No. XVII."

3. Clarification of the non-applicability of the tax-free exchange provision of the Internal Revenue Code to exchanges of male and female calves.

4. Recapture on disposition of land improvement costs, which were deducted currently, in the same manner that depreciation is recaptured on depreciable realty.

In my judgment these changes will put a reasonable stop to schemes which derive their profit from offsetting ordinary income deductions with capital gains in those cases where there is no real objective of an economic profit. In other these words steps will eliminate the "tax profit investor."

V. THE "OVERKILL" PROVISIONS

Nevertheless, the Treasury and the Ways and Means Committee have not stopped with these changes, but have gone on to far more radical provisions that will substantially destroy the essential qualities of American agriculture that I outlined above.

Pesticides, for example, although once hailed as the salvation of agricultural industry, are now being severely restricted for possibly causing detrimental affects on human beings through the animals and foods we consume. In our quest to eliminate certain harmful insects, we have gone too far and the benefits previously praised have now boomeranged and bombarded us with disaster.

So too will be the effect of provisions designed to make farming and ranching undesirable to the so-called "tax farmer" but also unattractive to those who have capital from non-farm sources that could be placed into agricultural enterprises. Care must be taken, not only to protect the small farm and ranch operations, but also the larger ventures that have provided an abundance of food and fiber for the American citizen. We cannot afford to jeopardize the American consumer by artifically and suddenly revolutionizing the economic base of the agricultural industry. As any economist would admit, the institutional influences upon the agricultural economy of the United States are profound. Any drastic changes, therefore, in the institutional perimeters must be carefully analyzed so that their economic impacts are thoroughly understood and that they would be in the long-run beneficial to the general welfare.

H.R. 13270 imposes unique restrictions on the agricultural industry. The House Bill: (1) creates The Excess Deductions Account concept, (2) singles out farm losses for treatment as a tax preference item under both the Limitation on Tax Preferences and the Allocation of Deductions, and (3) creates a presumption that a ranch is a hobby if its losses exceed $25,000 in any 3 out of 5 years.

Aside from the disastrous rejection of needed capital by these provisions of the Bill, these extremely complex concepts have a further basic difficulty. (The provisions also contain a number of apparent technical deficiencies which are discussed in Exhibit "A" hereto.)

VI. THE OBVIOUS DIFFICULTIES OF THE ACCOUNTING PROBLEM

A fundamental difficulty of the "overkill" provisions arises from the use of what the Treasury described as "deviations from good accounting practices." As an example, the Treasury stated that normally in businesses where the production or sale of merchandise is a significant factor, income can be properly reflected only if the costs of the merchandise are deducted in the accounting period in which the income from the sale of that merchandise is realized, i.e., the accrual method of accounting. As a policy of long standing, farmers and ranchers have been permitted to use the cash accounting method in which such expenses are deducted in full when incurred. The Treasury added that these agricultural provisions "were permitted for farm operations in order to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting." Apparently the Treasury would agree that those farmers and ranchers who have outside income of any substance should be restricted in the use of the cash accounting rules because some of that non-farm income might be offset by the farm losses.

This kind of reasoning will ont stand examination. Congress' past approval of the rancher's use of the cash method of accounting does not stem solely from a desire to spare him accounting problems. The most important reason for using the cash method is that under the peculiar nature of the agricultural business, the accrual method of accounting does not yield more accurate results. The typical rancher raises livestock both for sale and for adding to his breeding herd. If it were possible to always know which animals were destined for which purpose, then it might be possible to make allocations of ranching expenses between animals held for sale and breeding stock so that the accrual method of accounting would give a more accurate picture of income. Unfortunately, the rancher does not konw this until many months after the animal is born.

Moreover, many agricultural operators engage in both farming and ranching operations. The difficulty in accurately allocating expenses in such situations has been succinctly summarized by the Attorney General of the United States in a brief recently presented to the United States Supreme Court:

"[T]he nature of farming and ranching operations makes an effective accrual method of accounting difficult to operate. Each employee almost invariably worked on numerous phases of the farm's profit-making endeavors, such as planting and harvesting crops, raising livestock, repairing fences and barns, etc. Thus, it was exceedingly difficult to allocate salaries and the other expenditures among those farming operations." [9]

Frequently there is no way in surveying a farm loss that a farmer or rancher can tell how or in what percentage his loss arose. Yet the penalty provisions provisions apply. For example, suppose the loss can be allocated to a maize operation; the farmer-rancher loses his capital gain in culling his breeding herd in an equal amount. It is difficult to see any logic whatsoever in such result.

In summary, the provisions of H.R. 13270 require that every substantial farmer or rancher keep his books of account on the strict accrual basis or face the possibilities that a part of his usual deductions will be disallowed and that part of any capital gains he might have in future profitable years will be converted into ordinary income. Yet even if the expert accounting help is available to the farmer or rancher, the Attorney General of the United States has admitted before the U.S. Supreme Court that an "effective accrual method of accounting" is exceedingly difficult "to operate."

VII. RISE IN LAND PRICES

A major complaint raised before the Ways and Means Committee, as to this Bill, as well as by other bills pending before this Committee, is related to higher land prices for the small farmer.

This complaint can be considered only if answers are provided for the three basic questions:

1. Are "tax-profit" farmers really pushing up the price of land?
2. Do high land prices work for or against the bona fide farmer?
3. Do higher farmland values benefit the general public?

If we examine these questions separately and in detail, the results will demonstrate that the complaint is not only, in fact, unfounded, but may be premised on the opposite of the actual situation.

Are "tax-profit" farmers really pushing up the price of land?

An analysis completed in 1967 at Texas A & M University dealt with the Texas farm and ranch land market. The authors in their publications state:

"Factors considered relevant to a general analysis of Texas land market activity are per acre price, volume of land sales, size, mineral activity, availability of credit, interest rates, veterans land board activity and land use." [10]

Although the research study devotes considerable time and detail to each of these various influences upon land prices and statistically quantify some of their magnitudes, they no where mention the "tax-profit" farmer as a factor. If, in fact, the "tax-profit" farmer does exert an economic influence upon land prices, it must fall into a long list of other probably more important factors which these economists have readily identified. The study adds:

"Per Acre Price . . . . From 1947–49 to 1965, the relationship between average per acre land price and volume of land sales was that of an inverse correlation, land prices have consistently increased while the volume of sales has declined.

"Size . . . As a result of large tracts of land being divided and sold in smaller units, the median size land sale in many areas of the state has decreased since 1954. Agricultural use of the smaller tracts of land is primarily that of enlargement of existing farms and ranches. The smaller tracts are also being used for part-time farms, rural homesites, status, investment, speculation, and recreation. In this type of land market, small tracts with a variety of possible uses usually receive a higher per acre price than large units.

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[9] Petitioner's Brief in *United States* v. *Catto*, 384 U.S. 102 (1966).

[10] F. B. Andrews and Alvin B. Wooten. "Trends in the Texas Ranch and Land Market, Texas Agricultural Experiment Station, B1063, Texas A. & M. University, April, 1967.

"Mineral Activity . . . Mineral rights influence land prices and land market activity in some areas of the state as evidenced by the fact that sellers retained some or all of the mineral rights in 58 percent of the 1965 land transactions.

"Sales Involving Credit . . . The availability of credit is closely associated with the volume of sales. Easy credit encourages sales while a tightening of credit usually results in a decrease in sales volume. For example, in 1960, 50 percent of the total land transactions were mortgaged. In 1963, 73 percent of the total land transactions were mortgaged, and volume of sales increased approximately 27 percent over the 1960 level. Then in 1965, mortgaged sales accounted for only 60 percent of total sales, and volume of sales decreased approximately 40 percent.

"Interest Rates . . . A change in mortgage interest rates could alter the demand for loans and be reflected in land market activity. Decreasing or low interest rates tend to encourage mortgage loans and increase land market activity. Increasing or high interest rates tend to discourage mortgage loans and restrict land market activity.

"Veterans Land Board . . . Since its beginning, the Veterans Land Board has been responsible for 34,500 land transfers involving 2 million acres of land. . . . In the ranching area of Texas, characterized by large land holdings, the Veterans Land Board is inactive. In other areas of diversified land use, characterized by small land holdings, the Veterans Land Board strengthens the demand for land.

"Land Use . . . A change in land use from traditional agriculture to multiple use or to higher and better use is usually accompanied by an increase in land value. For example, nearly 28 million acres of land used for agricultural production are also leased for wild game hunting. Multiple use of these acres produces income from both sources, and these lands should command a higher price than comparable land deriving income from only one source.

"Many land markets have felt the impact of the urban demand for land. This impact on land market activity has been reflected through increases in land prices. In some counties located near large metropolitan areas, up to 65 percent of the 1965 land transfers involved out-of-country buyers."

The implication in the concept that "tax-profit" farmers and ranchers are forcing land to extremely high levels is based upon the idea that so-called "bona fide" farmers and ranchers must pay higher than economically sound prices for it or are not buying at all. It is true that the rate of increase in land prices has been due to active farmer and non-farmer demands. The Economic Research Service of the U.S. Department of Agriculture released a special study entitled *Farm Real Estate Market Developments* in December 1968. This publication pointed out that farmers represent nearly 2 out of every 3 buyers of land and have bought this land primarily for the enlargement of their operation. They have, in general, tended to be the more progressive operators in their area. In contrast, the nonfarmers which have purchased land have been in the market for investment and other reasons.

Despite the many different motives for entering into the land market, land values still correlate annual returns to land, the same as average dividend yields do with common stock. Land values have appreciated annually at 5.3%, resulting in a total return of 8.8% per year upon sale. The report, in its summary, concludes with this statement:

"Although local nonfarm demand will influence future land values in many areas, farm real estate price trends will generally bear close resemblance to the economic health of commercial agriculture."

The following quotations appear in the same article:

"Farm operators, who make nearly 2 out of every 3 purchases of farmland, generally are buying for farm enlargement. Because of the cost-price squeeze, increased output is one means of maintaining or increasing future income. Acreage expansion can increase production efficiency, particularly in the short run when adequate machinery and family labor are already available. And as long as these fixed costs remain fairly constant with additional acreage, the farm enlargement buyer may economically justify bidding up prices for an add-on unit.

"Enlargement buyers tend to be the more progressive and efficient farm operators in their community.

"Despite the complexity of market forces, the farmland market, in general, remains sensitive to expected economic returns.

"Although yearly increases in land values need bear no relation to annual returns in the short run, price trends do resemble movements in annual returns over time. For 1958–62, residual returns to land averaged around 3.5 percent of market value. Returns in the 1963–67 period were closer to 4.0 percent. Increases in land values showed a similar annual pattern—4.4 percent in 1958–62 and 6.6 percent in 1963–68.

"Perhaps the most substantial evidence that land values still depend heavily on agricultural returns is presented by regional data. Variations in rates of return among regions in 1966 and 1967 tended to parallel the regional pattern of land price movements. The Delta region, which has had the Lake States region, second only to Mountain States for the smallest increase in land values for the last 5 years, showed one of the lowest average returns to real estate during 1966 and 1967.

"If past rates of annual appreciation in land prices are considered along with net returns from farm production, the total returns would sufficiently explain the active farmland market of recent years."

This change in value of farmland as it relates more to the productivity of the land is dramatically illustrated by the fact that the major increases in dollar value of farm land have occurred during the last decade in the Delta and the Southeastern States of the United States, the Southern Plains and the Appalachian area. In contrast, some of the smallest gains have been recorded in the Lake States, the Mountain States and in the Corn Belt.

Probably no one statement can better summarize the future of the farmland market than the following paragraph which is taken from the same article:

"Urban influence will increasingly affect rural land markets. Numerous 'mini-booms' will erupt whenever and wherever rapid urbanization occurs. However, even though industrial and population centers are expanding dramatically, an enormous expanse of farmland will remain untouched by urbanization. Consequently, future value trends for land remaining in agricultural use will probably bear close resemblance to the economic health of commercial agriculture, and will continue to be influenced by national, agricultural and economic policy."

The proportion of voluntary sales to total farm real estate transfers has increased quite substantially. In 1955, for example, voluntary sales accounted for 70% of all total farm real estate transfers. By 1960, this figure has increased to over 80% and in 1968 was recorded at about 85%. In contrast, estate settlements and foreclosures have moved to much less significant levels. Farmers and ranchers are thus reaping the benefits of the higher land values and are probably carefully considering this land price appreciation in their total income expectations.

In a more recent issue of the "Farm Real Estate Market Development," (March 1969), under a heading entitled *Farmers Dominate the Market*, it emphasized that farmers made 59% of the purchases in the farmland market during the year ending March 1, 1968. This article stated:

". . . In terms of acreage, active farmers buy 3 acres for every two acres they sell, and therefore are increasing their land holdings.

"Despite dramatic increases in average farm size during the past 2 decades, farmland continues to be bought and sold in relatively small acreages. More than 7 out of 10 transfer in the year ending March 1, 1968, were less than 180 acres.

"Forces on the demand side of the market also encouraged transfer of relatively small tracts—the most important of these being farm enlargement. Purchases for farm enlargement accounted for 5 percent of sales occurring during the year ending March 1, 1968."

Do high land prices work for or against the bona fide farmer?

Land is recognized as the principal asset of the American farmer and rancher. According to USDA figures farm real estate represented on March 1, 1968, almost 81% of the total farm assets. Rising farmland values have, of course, forced land into this unique asset position, although it has been the major asset for numerous years. The total value of farm real estate has increased from $130 billion in 1960 to $194 billion in 1968.

This USDA publication emphasizes the extent of bigness already in the industry, that expansion can occur as easily through land rental as purchase, and that the higher land prices provide farmers more credit since land is his principal asset.

The ability of land to serve as a larger credit base which can be used to finance additional land purchases is also brought out by Professor Raup in his article.[11]

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[11] Raup, op. cit., note 3.

Still other concepts of farmland value gains are tied to technological advancement in the society. The following statements are indicative of these ideas:

". . . The evidence, both theoretical and empirical, indicates that the expectation of rising income from technological advance in conjunction with supported farm prices (and from increasing urban demands as well) has been important in contributing to the rise in farmland prices. Expected income increases, because technological advance lowers unit costs and increases individal farm incomes with supported prices. thus providing an incentive to expand farm size, which in turn puts an upward pressure on land prices. Farmland prices rise as many farmers bid for land to capture the gains of technological advance on individual farms thus vanish as the competitive process of acquiring land forces up land prices and absorbs the gains from technological advance.

"But someone gains. The retiring farmer or landowner who sells farmland at an inflated price reaps the benefits of the technological advance. And this process will continue to push up farmland prices as long as farm prices are relatively stable and the march of technological advance continues." [12]

If as some witnesses before the Ways and Means Committee said, the effect of H.R. 13270 will result in lowering farmland prices, the result would be disasterous. As indicated above, many farmers and ranchers have borrowed funds and pledged their lands as collateral. A reduction in farm land prices would almost certainly mean that many outstanding loans based on increased land value would be in jeopardy and could be called under the terms of most loan agreements because of inadequate security. In turn, this could have the adverse compounding effect of causing businesses in local communities dependent upon farming and ranching to close their doors. The trickle of unemployed from rural to urban communities would increase substantially.

The ad valorem tax base

The property tax payments so important for local and county government programs, including such essential items as schools and roads, also would be in great danger if, some contend, there would (and should) be a decrease in farmland value as a result of enactment of the House Bill. It is inconceivable that the present local governmental fuctions could continue with a meaningful reduction in the price of land.

During the past 25 years taxes on farm real estate have increased almost five fold; those taxes have gone primarily to support rural schools, which expenditure does not substantially benefit the non-farm resident. Hence, it is important to note that the farmer residing on the farm benefits as to the cost of education of his children (as well as other benefits) from the infusion of outside capital into property purchases.

VIII. THE COMPETITION ALLEGATION

Another complaint before the Ways and Means Committee comes from the assertion that the outside capital creates unfair competition for the "family" ranch. The idea apparently is that the farmowner with non-farm income in high income brackets does not have to depend on farm operations for a livelihood; the high income bracket taxpayer can demand less for his products than the regular farmer, who needs to make a profit to be able to stay in business.

This assertion cannot stand analysis. *There is no set of "farm loss" circumstances under which an economic loss produces a more favorable tax result than an economic profit.* The greater the economic profit from a farm, the greater overall economic benefit to the farmer or rancher. If the economic profit of the agricultural enterprise can be increased, the farmer or rancher is financially better off, despite the imposition of income taxes on the farm profit, simply because the increased economic profit is never going to be taxed at 100%.

The fallacy of such assertion comes from the premise that a farmer or rancher will sell his product for less than its market value. There is no evidence to support such illogical, unreasonable course of action. On the contrary, the livestock industry traditionally is one in which the seller gets all he can in a buyer's market.

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[12] William E. Martin and Gene L. Jefferies, "Relating Ranch Prices and Grazing Permit Values to Ranch Productivity," *Journal of Farm Economics*, May, 1966.

IX. SUMMARY

In conclusion, there are certain changes I believe should be made in the Internal Revenue Code to eliminate what I call the "tax-profit" operation.

However, the other proposals in the House Bill (Excess Deduction Account, farm losses in the Limitation on Tax Preferences and the Allocation of Deductions and the so-called hobby loss change) would cause at least two disastrous economic changes to the substantial farmer or rancher. These are: (1) the drying-up of new capital so badly needed in agriculture, and (2) chaos from an impossible accounting situation.

As to the farmland price situation and the alleged improper competition, the facts demonstrate that arguments based hereon for his Bill, or others, cannot in my opinion, be supported.

Gentlemen, while I am grateful for your attention to my remarks, I appreciate even more your consideration of the problems of the American farmer and rancher in light of federal tax laws and the proposals for changes therein.

EXHIBIT "A"

TECHNICAL DEFICIENCIES IN H.R. 13270

1. It is not clear whether the Excess Deductions Account under the proposed Section 1251 can ever have a negative balance. According to subsection (b)(3):

"If there is any amount in the excess deductions account at the close of any taxable year (determined before any amount is subtracted under this paragraph for such year) there shall be subtracted from the account—(A) an amount equal to the farm net income for such year . . . ."

Thus it would seem that a negative balance is permitted since the year's farm net income could easily exceed the amount in the account.

If a negative balance in the Excess Deductions Account is intended, the proposed Section 1251 does not appear to allow credit (i.e. subtractions) for profitable years prior to the first year of a farm net loss. The proposed Section 1251(a) states that it "shall apply with respect to any taxable year only if—(1) there is a farm net loss for the taxable year or (2) there is a balance in the Excess Deductions Account as of the close of the taxable year after applying subsection (b) (3) (A)." In the preceding profit years, there is by definition no farm net loss nor is there any balance in the Excess Deductions Account at the close of any of those taxable years. There is no balance in the account because additions to the account are made for farm net losses (which did not arise) and subtractions are made only if there is an amount already in the Excess Deductions Account.

2. Proposed Section 1251(e)(2) defines "farm net loss" as including those special deductions allowable in respect to land under Sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land). When the net farm loss is added to the Excess Deductions Account, it has the effect of adding a portion of these special land expense deductions with respect to the account. The balance in the Excess Deductions Account will affect the character of gain on sale or exchange of land only to the extent of the land's "potential gain." Proposed Section 1251(c)(2)(C). If no deductions under Sections 175 or 182 have been taken with respect to the land within 5 years, the "potential gain" in the land is zero (Proposed Section 1251 (e)(5)) and thus any gain attributable to those expenses will never be recaptured. Yet such conservation and clearing deductions will remain in the Excess Deductions Account and will convert the capital gain on the sale of some other asset which is totally unrelated to the land, such as breeding stock, into ordinary

3. Proposed Section 1251(b)(5)(B) provides that upon the gift of farm recapture property the donor's Excess Deductions Account is transferred to the donee if the potential gain on the farm recapture property given in any one year

income.

period exceeds 80% of the potential gain on farm recapture property held by the donor immediately prior to the first of such gifts. This rule appears to lead to unintended hardships for the uninitiated and to be of little effectiveness for the careful planner.

If, for example, a rancher should give half of his ranch (and presumably one-half of the farm recapture property and one-half of the potential gain thereon) to one son, the donee would not be required to take any of his father's Excess Deductions Account. If more than 12 months later, the rancher gave a second son the remainder of the ranch, that donee would be required to take his father's entire Excess Deductions Account. With careful planning, however, the strictures seem easily avoided. For example, a farmer could give his son an undivided 80% interest in the farm without causing a transfer of his Excess Deductions Account. Twelve months and a day later, he could give the son another undivided 16% (being 80% of the remaining 20% of the original farm). At this point he will have transferred approximately 96% of the original farm without a transfer of the Excess Deductions Account. By waiting another 12 months and a day, the remaining 4% of the original farm could be given to a charitable organization who would then succeed to the entire Excess Deductions Account. The farmer could then again take up farming with no balance in his Excess Deductions Account and the son would have received 96% of the original farm with no transfer of the account.

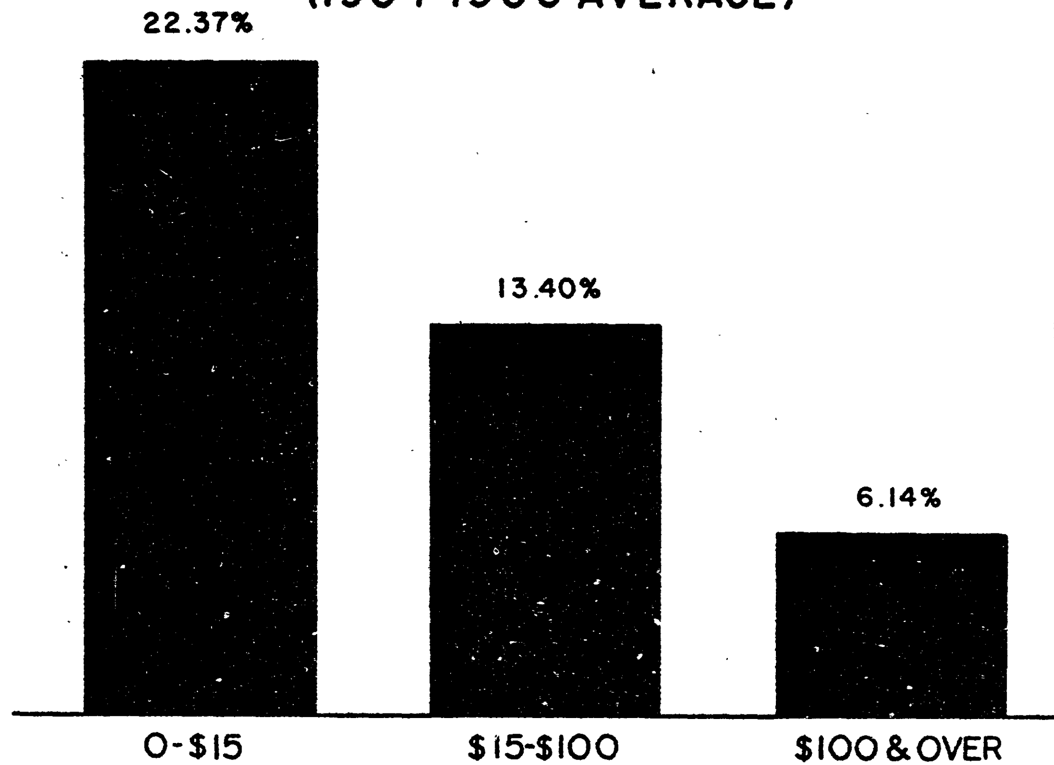
4. The proposed Section 1251(d)(6) provides that in certain transfers of farm recapture property to corporations, the "stock received by a transferor in the exchange shall be farm recapture property." Securities received in this exchange are not so treated. This permits the avoidance of the Excess Deductions Account rules by careful planning. The farm recapture property can be transferred to a corporation for all of its stock and bonds equal to almost all of the value of the transferred property. Such an exchange generally will be tax free under Section 351 of the Internal Revenue Code. The bonds (i.e., "securities") can then be sold and none of the gain thereon would be affected by the balance in the Excess Deductions Account because the bonds are not farm recapture property.

5. The depreciation which contributed to a taxpayer's farm net loss will be included in addition to the Excess Deductions Account. When that depreciable property is sold, the gain equal to that depreciation will be recaptured and treated as ordinary income under the provisions of Section 1245 of the Internal Revenue Code. Since the tax benefits arising from the depreciation deduction will have been totally eliminated by the sale, there appears to be no reason to leave any of that depreciation deduction in the Excess Deductions Account where it will reduce the amount of capital gains on the sale of some other asset. The depreciation deduction ought not to be recaptured twice.

CHART 2

NET FARM LOSS AS A PERCENTAGE OF AGI CLASS (THOUSANDS)

(1964-1966 AVERAGE)



PRICES PAID AND PRICES RECEIVED BY FARMERS

ANNUAL, U. S.

(INDEX NUMBERS 1957-59=100)

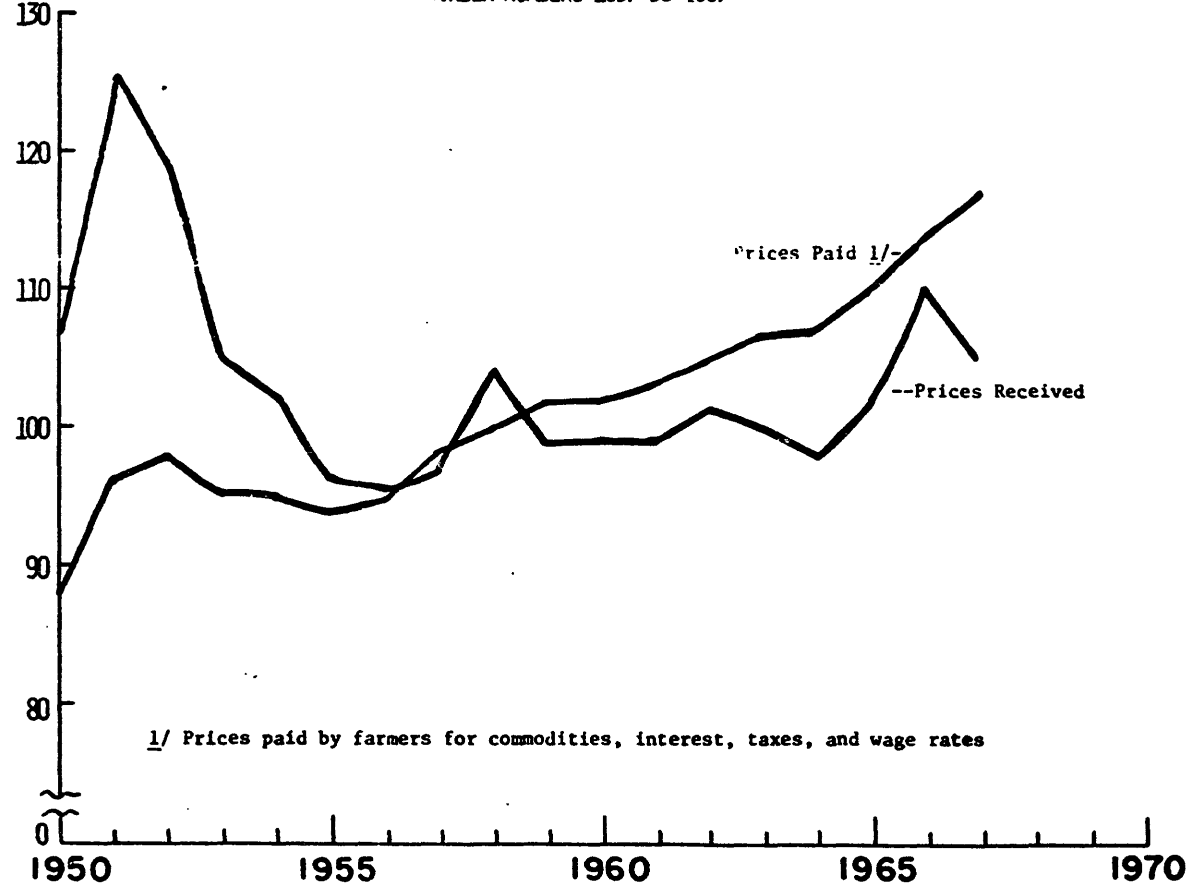


CHART 1

Mr. CONNALLY. May I now introduce to you Gen. Earl Rudder, the chancellor of the A. & M. University system who is one of the distinguished citizens not only of our State but this Nation. He was the colonel commanding the ranger force that landed on Omaha beachhead. I recall Gen. Omar Bradley said of him he was one of the two finest officers under his command during World War II.

I would like to present Gen. Earl Rudder who also has a statement.

The CHAIRMAN. Good to have you today.

Senator CURTIS. Mr. Chairman, Nebraska beat Texas A. & M. Saturday 14 to zero. I can't say I am sorry, but I am sorry they had to do it to such nice people.

The CHAIRMAN. General Rudder.

STATEMENT OF EARL RUDDER, PRESIDENT, TEXAS A. & M. UNIVERSITY

Mr. RUDDER. Mr. Chairman, and members of the committee, I will tell you, Senator, you didn't get a first on that because Senator Long's great school over in Louisiana beat us the week before by a bigger score than you did.

I come to you this morning with Governor Connally not only as an executive of one of our great land-grant universities of this Nation, and we have many of them, and I know that we are all quite proud of the program that they have had back through the years, in fact a little over 100 years right now. I also come to you as a cattleman and I know something of the work that is being done in these land-grant colleges, and I also know something of the problem that faces this committee in looking at what sort of moneys are going to be allowed to be spent for the development of the ranches and the farms of this Nation.

I would like to point out to you a thing which I am sure you know and you have seen, but today farmers and ranchers are getting older and older and the young people just are not staying on the land and one of the reasons they are not is that good chart Dr. Uvacek had a moment ago—the farmer's income stays kind of level and everybody else's income goes up, and the youngsters we have today are adroit and smart and they say there isn't much opportunity for them on the farm, "I am going where the opportunity is," so the average age is 51.3 years as the Governor has already pointed out to you, and the average household on the farm is 3.6 people. They have lived there for 15 years, they have a high school education. The value they have in the investment in the farm is an average of $51,000 and they work 79 days on the average off of the farm.

I submit to you gentlemen, simply this: It seems to those of us who may live off the farm and go back there and work and spend some money and develop it, and so on, are somewhat suspect with what to do with our money. However, the fellow who lives on the farms, goes off and works and brings money back, he seems to be legitimate.

Also another thing that I have observed, in the testimony and reflected all over our Nation today, is it seems, that the person who is successful and makes a little money is already a suspect. We have got the greatest Nation on the face of the earth and, as the Governor pointed out in his chart there, the lower one, we see here he is not spending more money, the average man is not spending more money, for food that he needs, he is spending percentagewise less money all the time, and I ask you why? One of the reasons, in my opinion, is because the land-grant colleges of this Nation, and Nebraska is one of them. The illustrious Cliff Hardin, Secretary of Agriculture, I like to call him a good friend of mine—but he wasn't so good last week—I told him if he had any influence out there, to remember also that these private ranchers have worked diligently in research and extension, and they have been partners with this Federal Government at least since 1862.

As the Governor so ably pointed out a while ago, 5 percent of our people produce the food and fiber needed for the 100 percent. Where else in the world does this happen? It is a pretty good system that allows this to happen.

Well, suppose we were Russia today, I am told they have 50 percent of the people producing food and fiber for the 100 percent. This is where the United States was in 1900, 69 years ago.

Suppose we had to go back to that? That means we would have to take out of the work force today some 45 percent of the people and put them back to producing food and fiber. Well, I don't know where we would get the people to carry on this GNP escalation that is essential if we are going to survive as a prosperous nation.

A lot of it has been done because of your land-grant colleges and also a lot has been done because people are willing to work at two jobs. There are not many people in town that don't work at one job and then another if they can't make a living on one and this is what the farmer has done.

Out in west Texas at the turn of the 1950's we had a little community there of 5,000 people. The people over here in Baltimore, the Martin bomber people, needed an outboard section of the Martin bomber built and they started building it before the Korean war and we ended up in Brady, Tex., some 1,500 miles away, producing the outboard section of the Martin bomber in this little community, and I venture to say there wasn't a single person there who had any expertise or skill in building a wing of the bomber but in a very few short weeks, with the direction of some of the experts in the business, we were producing the outboard section of this Martin bomber at Brady, Tex., for less money and a better quality than they could produce it right here in Baltimore. We were shipping it all the way up here.

Well, I saw those farm people there, and this is a rural community, there wasn't any industry in the community, I saw them convert from the way of life that we had, and you will recall in 1950, 1951, Governor, it was the beginning of the 6-, 7-year drought and there wouldn't have been a farmer left in that community if they hadn't had something to supplement their income with.

So I think it is a real healthy situation that the farmer goes into the city and works in the communities and works, and vice versa.

I have some good friends who are so-called windshield farmers, but I know their families are much better off because when Friday afternoon comes they load up and go out to this farm. I agree with the Governor there isn't such things as a hobby farmer, they are all trying to make money out of it.

So I beg you not to completely wipe out this way of life of ours. This way of life of ours has helped build this Nation to what it is.

In addition to this through your agriculture program through the years we have put in great assets of this Nation. As I said, I happen to be a cattle farmer. I went to our great grains program 5 years ago; and 3 years ago I got rid of all the brush. For 3 years nothing happened because it was dry. This year, 3 years later, we have grass out there almost as high as this table. It is because you wrote a law making it possible for me to put some of my dollars in with the Federal dollars for soil conservation and today we are going to have the best production in the history of this ranch, which has been in our family for 40 years and I guess I will make money or break even with it this year.

I say unless we continue to do research and find better ways of doing it, and certainly you share with us here, that the time will come when we won't be able to produce the necessary food and fiber, when prices that we pay for food and fiber won't go down as shown on the chart; but will go up instead.

I can remember back in the 1930's, and I think most of you are old enough to remember, that we plowed down pigs, corn, hogs, cattle, and everything. It could easily have been said then "that we don't want any more research. We are not going to spend any more money on research, we are not going to spend any more money developing these places," but if we had we would still be back with the Russians today.

So I beg of you to stay partners with these land-grant colleges, let us put money in, and let's develop farms and ranches. I agree with Governor Connally you already have got the means to go in and pick out these people who are trying to dodge taxes, and pick them off. You will find in farming and ranching today that the $53,000 that I spoke of a moment ago is the average investment; but for the cattle raiser that is going to get $3,100 return, he has to have an investment today of something like $112,000. That is a pretty good sized investment, and that doesn't include anything for his labor. That doesn't pay him anything for his own effort.

Today some of the big ranchers, and some of the people that have some money, put some money into these research programs, and I am afraid under the proposed law that you have before you now, that this will cease to happen.

We have a ranch in South Texas today that gives Texas A. & M. University, $200,000 a year in range research. Why? It is in order that we might develop better methods, better ways of growing grass and producing the food and fiber that this Nation needs at a more economical rate.

Another thing I would like to point out with respect to cattle breeding: we don't develop a new breed just overnight. A lot of people would say LSU and Nebraska, and so on, have produced all the new great breeds of this Nation. Well, this simply isn't so. We have helped them, it is true, but it is usually somebody who has got enough money and backlog of capital that can go into this breeding program that will take anywhere from 3 to 10 years to develop a new breed. So these people, in my opinion, have got to be given some latitude.

The farmers of Texas have given plots for the developing of new crops and seeds and this sort of thing. There are 4,486 plots furnished by farmers and ranchers in Texas to assist Texas A. & M.'s research program.

So I simply say this: If we try to roll back every ounce of investment on the part of the individual we are likely to kill some of the great jumps that we have made forward in this agriculture production.

Remember under the system that we now have we have moved further, quicker than any other nation on the face of the earth, and I just hope that we don't do anything that will cause this to come to an abrupt end.

Thank you, sir.

Mr. CONNALLY. Mr. Chairman, may I very briefly introduce two other gentlemen at the table, Mr. Marvin K. Collie, who is my partner, and who has been a distinguished tax lawyer since 1941 and Dr. Ed Uvacek, one of the agricultural economists from Texas A. & M. University who is responsible for the preparation of the charts.

Again may I express my gratitude to you for the opportunity to appear here today.

The CHAIRMAN. Thank you very much for a very fine presentation.

(Gen. Earl Rudder's prepared statement follows:)

STATEMENT OF GENERAL EARL RUDDER, PRESIDENT, TEXAS A&M UNIVERSITY

INTRODUCTION

Gentlemen, while I am the President of the Texas A&M University System, I am also a cattleman, a native of the Southwest, and an individual quite familiar with the problems currently being experienced by agricultural producers of this area of the Nation. Although it would be difficult for me to refrain from the inclusion of some academic material pertinent to the situation, this testimony is offered to you primarily from the viewpoint of these latter positions.

I have been concerned about those individuals who have ranches or farms but apparently intend only to have some type of "tax profit." Certainly no one can defend such individuals as a matter of equity because it is readily recognized that they would, in fact, have some distorting affect upon the agricultural economy. I am here to try to put the problem into its proper perspective. Certainly some congressional action is warranted, but we should not have the severe economic upheaval due to "over-kill" provisions.

Care must be taken, not only to protect the small farm and ranch operations, but also the larger operations that have provided economical food for the American citizen.

Let us first examine the make-up of the modern American farmer and rancher, the plight he is currently facing, and the benefits which have accrued to the American consumer under the current framework of agriculture which has developed.

THE MODERN FARMER AND RANCHER

In order to better understand the type of agricultural environment in which we are currently operating, let's briefly look at the farmer and rancher of the 1960's. Today's average farmer or rancher is 51.3 years of age, has an average household size of 3.6 persons and has lived on his farm for over 15 years. He has completed 4 years of high school, operates a 351.6 acre farm which has a value of close to $51 thousand, and works about 79 days off the farm each year.[1]

Governor Connally has mentioned the "outside" work and income of the farmer or rancher. I would like to develop this topic further. This work outside of the farm is quite interesting, in that it has become a way of life for most farm families. For example, according to the latest census, 46% of all farm operators in the United States reported some days of work off their farms and 32% reported such work amounted to 100 days or more. There is a significant regional difference in this proportion too. Almost one-half of the farm operators in the Western region of the country reported some off-farm work while this proportion was 49% in the South and 43% in the North. Of all farm operators working off their farms, 69% reported working 100 days or more, and 56% reported

[1] This data from 1964 Census of Agriculture, U.S. Department of Commerce.

working 200 days or more. In the West, 62% of the operators reporting work off farms, worked 200 days or more, whereas, in the North only 52% reported 200 days or more.

As might be expected, the proportion of farm operators working off the farm and the number of days that they worked varied according to the age of the operators. Sixty-three percent of the operators under 35 years of age reported working off their farms, while 54% of the operators in the 45 to 54 age bracket showed off-the-farm work. In essence, this data merely emphasizes the fact that the modern day farm operator spends a considerably larger proportion of his time working off-the-farm than most people realize.

Not only is off-farm work important in a time aspect—it represents an important soure of income to such farmers (Figure 1). In the latest issue of the *Farm Income Situation* released by the U.S. Department of Agriculture, some rather interesting information is offered regarding net income realized on farms versus off-farm income. The report shows, for example, that in 1968, operations which had less than $2,500 farm sales reported, 85% of the total income of the farm operator's family came from off-the-farm sources. The larger size classifications of farms, those with less than $10,000 farm sales during the year, relied somewhat less upon off-farm income, actually 53% of their total income. Moving to the largest category of farms, those with $40,000 sales or more, off-farm income contributed only 17% to the total farm operator's family income. (See accompanying Tables 1, 2 and 3.)

In addition to off-farm part-time employment, supplemental returns from land-based activities such as hunting, fishing, and oil leases contribute significantly to the bona fide farmer or rancher's total family income.

Such activities, to most rural residents, are considered as a part of farm income, although there is a distinction among them for tax purposes. Strangely enough, limitations placed upon the farmers and ranchers with regard to outside income is in direct opposition to the U.S. Department of Agriculture goals and expenditures aimed at stimulating such supplemental income.

In the Yearbook of Agriculture for 1968, *Science for Better Living*, Secretary Freeman made this statement with regard to non-farm income:

"Working closely with farmers and other rural people, the U.S. Department of Agriculture is helping to stimulate a rural renaissance.

"Private enterprise is being attracted to the countryside. Rural people, both farm and nonfarm, are taking advantage of government supported opportunities to establish part-time businesses or trades.

"On thousands of farms, picnic and camp sites, riding stables, game and fishing preserves, winter and water sports facilities have become supplementary and even primary sources of income."

Since agriculture is a highly variable income source, fluctuating with economic conditions in the nation as well as climatic changes, it is also a business enterprise which has tremendous variations in profitability. Net income can sometimes occur, but net deficits are as equally likely. Whenever farm losses do occur, it is obviously to the benefit of the farmer or rancher to use such loss to offset any non-farm income; indeed it is imperative in many cases.

BEEF CONSUMPTION AND RETAIL PRICES

Because of increased production, the development of the commercial cattle feeding industry, and increased efficiency throughout the production and feeding levels of the cattle industry, beef production in the United States increased from approximately 13½ billion pounds in 1955 to almost 21 billion pounds in 1968. Consumer demands also increased substantially during this period so that per capita consumption was able to increase from 82 pounds per person in 1955 to 109 pounds per person in 1968 without any major change in price levels. Some of this increased demand exhibited by the consumer was a result of increased disposable income, although a substantial proportion of it was due to the drastically reduced consumption of other red meats. In fact, during this entire period when beef consumption per person increased 27 pounds, the retail price level for beef showed an increase of only 20 cents per pound.[3] (Figure 2)

Despite this substantial increase in quality, a rise in beef quality, and almost constantly increasing costs of production, the American consumer has been blessed with an average retail price only slightly higher than that which existed

[3] Gene L. Swackhamer, "The Growth of Corporate Farming," statement before the Colorado Cattle Feeders Association on February 8, 1968.

in the mid-1950's. Even a large portion of this small increase can be traced to the increased demands for consumer services at the retail level in the form of packaging, closer trimming, boning, etc.

Although today's consumers are apalled by the relatively high prices of beef in the retail counter, much of the criticism is really focused at the levels for the so-called "high-price beef cuts." Unfortunately, all of a beef carcass is not composed of high-price cuts and many "low-price cuts" are often ignored by the consumer picketers. We must remember that only about a quarter of the total beef carcass yields steaks, another quarter roasts, a third quarter miscellaneous cuts such as hamburger, stew meat, etc. and the final quarter of the carcass is lost through shrinkage, cutting loss, and trimmed fat and bones.

Let's spend a minute examining these retail beef prices that have exited some housewives. The United States Department of Agriculture bases its average retail price for beef on prices collected by the Bureau of Labor Statistics. These are basically gathered for use in preparing the consumer price index. The Bureau's purpose is to measure changes in food prices, rather than their absolute levels. Even though the Bureau goes to considerable lengths to obtain a good sample of cities and types of stores in which to gather these prices, the data really offers servere problems for the Department of Agriculture in that it does not take price specials properly into account.

For example, the advertised price specials that are usually offered on Thursday, Friday and Saturday represent the majority of the retail food sales. Red meat and poultry are the most frequently used items on such sales since they attract people into the store. When the retailer puts a certain cut of beef or broilers on sale during the weekend, the volume of the products sold at these reduced prices is often several times the volume sold at regular prices. Unfortunately, the Bureau of Labor Statistics collects retail food prices on Tuesday, Wednesday and Thursday of the enumeration week, and does not weigh the prices of food according to the specials to reflect this increased volume sold. The average prices reported by the Bureau, therefore, overstate the true average prices of foods. The National Commission on Food Marketing emphasizes this error and worked with the Department of Agriculture in an attempt to revise retail prices for red meats and poultry in recognition of this problem. In the year 1964, for example, the retail value of choice beef was reduced 7 cents per pound, for choice lamb 3.6 cents per pound, for pork 4.1 cents, and for veal 3.8 cents per pound. No data are available with which to compute revised retail prices back into the 1950's, but it can be assumed that there is an overstatement of retail prices occurring back as far as 10 or 15 years. Apparently, however, the use of price specials in supermarkets has increased in the more recent years, so it seems likely that the overstatement is probably greater in the 1960's than it was in the mid-1950's.

Even when this overstatement of the retail prices is ignored, the retail price for beef has shown very little rise during the last 10 to 15 years. (Figure 3) Beef, of course, means cattle, and the prices of high quality fed cattle have reflected about the same basic type of price pattern as the retail beef cuts. The typical rancher, however, does not produce beef, but rather, feeder calves, that today move into a highly merchandized and specialized cattle feeding industry. This cow-calf producer's output is calves, and they are his only major source of income. Prices received by farmers and ranchers for calves, however, during the last 20 year period have been hardly encouraging.

Texas cattlemen, for example, received an average of $26.27 per hundredweight for live calves in 1968. This represented the highest return from calves, with the exception of the record established in 1951, when prices reached over $30 per hundredweight. (Figure 4) Price levels for calves in Texas have remained within a relatively narrow range ever since the latter 1950's, even though as we have indicated earlier, the costs involved in producing such calves has increased at about the same rate as inflation.

The question, of course, is how can cattle producers pay more for the inputs to produce beef, yet still sell the commodity at relatively the same or even lower levels. The answer to this, of course, is that they cannot, at least not without losing money. A recent Texas A&M University study indicated, for example, that in order to attain a $3,000 a year return to labor and management, it would require an average annual investment of about $4,900 in hog production, about $21,000 for broilers, $48,000 in dairy, and a healthy $112,000 investment to get a $3,100 income from the cattle business.[3]

[3] Tom E. Prater, "Investment Requirements for an Approximate $3,000 Return to Labor-Management," Texas Agricultural Extension Service, Texas A. & M. University.

Similarly low returns were found through a research study of costs of western livestock ranches by the U.S. Department of Agriculture.[4] This analysis deals with actual commercial cow-calf reaches in the Northern Plains, Northern Rocky Mountains, and Southwestern areas of the country, during 1967 and 1968. Returns for the Southwestern ranches were consistently lower and yielded about a $6,000 to $7,000 total return to operator labor, management and capital with a $212,000 to $220,000 total ranch investment. Certainly, the investment attractiveness of such a cow-calf enterprise would be quite dubious to a businessman considering this field of endeavor.

According to the 1964 Census of Agriculture, there were about 2.3 million farms and ranches in the United States that reported having cattle and calves. Of that total, however, about 1.3 million reported maintaining beef cows while another 1 million were farms that had no cows other than milk cows or dairy type. Let's now examine these 1.3 million farms and ranches. It is assumed that, since these operations maintain beef cows, they are in the business of raising beef calves. The Census shows us, however, that of these 1.3 million cattle operations, 69% had less than 30 head and there were, in fact, only 3,645 farms in the entire United States that had 500 head of beef cows or more. Of this total a mere 1,010 farms in the whole country had 1,000 head of beef cows or more. (Table 4)

TABLE 4.—*Numbers of cattle and calf farms and ranches, 1964 census*

Farms with cattle and calves	2, 283, 881
Farms with no cows or other than milk cows	959, 969
Farms with beef cows	1, 323, 912

Of the 1.3 million farms with beef cows 69% had less than 30 head; only 3,645 farms had 500 head or more; just 1,010 farms had 1,000 head or more.

EXPECTATIONS FOR PROFIT

At this point one should examine the concept of expectations of profits on the assumption all legitimate farmers and ranchers have this attitude.

In the recent Ways and Means Committee report on this Bill, there was a reference to data which indicated that there was a strong trend toward losses increasing as the taxpayers adjusted gross income increases.

Actually, how profitable is the cattle business? Should one really expect huge profits or substantial losses? According to data collected by agricultural economists at Texas A&M University, it costs an average of about $90.50 to raise a calf, or keep a cow for a year in Texas, if all costs are considered.

This composite acerage costs is obtained by totaling the various expenses involved in maintaining a cow for one year.[5] (Table 5.)

TABLE 5.—*Costs of keeping a cow for 1 year*

	Expense
Land charge*	$28. 70
Depreciation	5. 60
Interest-herd capital**	10. 70
Replacement cost	5. 55
Operating costs	39. 95
Total	90. 50

*Land cost based upon fair lease or rental value.
**Considers cow cost and a portion of the bull.

NOTE.—No charge for labor or management is included.

Let's now look at the return Texas ranchers probably received during the Report's test year—1966. In that year, the Texas calf crop averaged 84%, the average price received for calves was $24.60 per hundredweight and the estimated weaning weight for calves ranged between 350 and 400 pounds. Assuming that our typical cattleman in Texas during 1966 produced a 400 pound calf, sold it for $24.60 per hundredweight, and had an 84% calf crop. Under these conditions

[4] Wylie Goodsell and others, *Costs and Returns Western Livestock Ranches*, 1968, USDA, July 1969.
[5] Tom E. Prater, "Estimates on Annual Beef Cow Cost by Areas," Texas Agricultural Extension Service, Texas A. & M. University.

the return per cow would be $82.66. Since our cost estimates, however, were $90.50 per cow, this left the rancher with a net loss of $7.84 per cow during the year.

It is easy to see with these figures that the larger the herd size, the larger the loss would be on any particular operation. Although there may be some economics of scale involved, they are not sufficient enough to change these basic cost figures very substantially. The loss recorded, therefore, of $7.84 per cow during 1966 would mean a $78.40 loss for a 10 cow operation, a $7,840 loss for a 100 cow operation, and a $78.400 loss for a 1.000 cow operation. Thus, our analysis of probable costs and returns of Texas ranchers in 1966 yields exactly the same type of average loss-size operation relationship as the Report figures. A similar computation of the 1967 statistics indicates that the average Texas rancher realized a net loss of only 04.50 per cow during that year, substantially better return situation, but still recording a loss.

These loss situations are more common to the cattle businesses of the Southwestern part of the United States. A recent U.S. Department of Agriculture report shows that cattle ranches which operated in the Southwestern part of the United States during the period of 1963 to 1967 had considerably higher operating expenses per unit of production than did similar types of ranches in the Northern Plains and the Northern Rocky Mountain region. These operating expenses averaged 25% higher in the Southwest, so that it is more likely for difficulties to arise in maintaining profitable operations in that section of the country than in the other. Also adding to this less favorable cost situation is a generally lower livestock price level in the South, and consequently smaller returns.

Expectation, according to Webster, is the prospect of the future. Unfortunately, cattlemen are not noted for their ability as fortune tellers. Even the feeding of cattle is highly speculative and very unpredictable. It is not uncommon to experience severe losses for one, two, or even five years in a row and then do much better for the next five. Most of these unprofitable periods are usually felt when the margin between the price paid for feeders and the price received for finished cattle, falls below zero. (Figure 5)

Agriculture, and particularly livestock production, is a highly risky and variable income generator. Not only is the farmer and rancher subject to the elements of nature, but he is also tremendously affected by national situations, economic crises, government programs, and the whims of the American consumer and her demands. No other segment of the economy involves such a wide array of risk and uncertainty, yet at the same time, offers both a short, as well as hazy, planning horizon.

AGRICULTURE NEEDS OUTSIDE CAPITAL FOR RESEARCH

Governor Connally has referred to some of the reasons for the necessity of outside capital. I want to touch on some aspects of the use of capital in agriculture.

It has not been more than about 40 years since agricultural producers of the United States struggled with primitive tools behind a mule to scratch the surface of the earth. The scientific and technological progress of our agriculture has been so rapid that few of us recognize that back in 1937, it required one person employed in agriculture to provide enough food and fiber for 10 persons in the Nation. Yet, by 1967, just 30 years later, one farmer or rancher produced abundantly for more than 40 persons.

No agricultural commodity has shown more progress than that of livestock, particularly cattle production. The first Hereford bull imported in 1817 by the distinguished American statesman, Henry Clay, bears little resemblance to the modern breed of Hereford cattle so prevalent in our country today. Similarly, the first Shorthorn cattle imported in 1783, the original Brahman stock in 1853, and the initial Angus importations in 1873, held the basic seeds of new breed developments in the United States. Many of these original cattle are hard to identify when reviewing the currently accepted standards of these breeds. Throughout the years since their importation, they have been bred, crossed, and recrossed and now yield superior animals designed to reproduce effectively, gain weight efficiently, and yield carcasses with a high proportion of trimmed retail cuts.

It has been through the efforts of the Agricultural Experiment Stations at land grant institutions such as Texas A & M University, and the U.S. Department of Agriculture that the basic research and extension work was performed. But more than that, it was the brave and industrious cattleman of yesterday using applied research in their own herds who have developed livestock to the point where it now yields more meat, at a reduced cost, with less land, and less manpower than ever in history.

Agricultural research contributions have been tremendous, particularly when you consider the small amounts of funds devoted to it in relation to other research investments. During 1966, for example, the total agricultural research expenditures by the U.S. Department of Agriculture and the State Agricultural Experiment Stations was $331 million. Industry contributions to agricultural research in that same year were $473 million. Of course, we are talking here about total agricultural research spending, not just research for livestock or cattle. Some idea of the small amount of expenditures devoted exclusively to, say, beef cattle research can be obtained from these comparisons. In 1966, the total budget outlay for the U.S. Department of Agriculture was $5.9 billion, of which only $167 million was spent for research. Beef cattle and related research work, including such things as consumer acceptance, control of insect pests, and economic efficiency in marketing represented only $10.3 million of this total. Another $18.1 million were spent by all the State Agricultural Experiment Stations on beef cattle research, bringing the national total to only $28.5 million.[6]

At first glance, this figure looks high, but compare it with the research and development expenditures of 1968 for some major corporations: IBM—$410 million; Texas Instruments—$130 million; Xerox—$76.8 million; and Merck—$55.4 million.[7]

Such public research spending is frequently, however, not all that is required. For example, the screwworm infestation of the Southwest was attacked directly by livestock producers who contributed a total of $4 million to help research efforts to erradicate this economically important pest. Recognizing the concern of the producers and encouraged by their financial backing of the project, the government came to the aid of the program with additional funds and assistance. As an administrator at Texas A&M University, I can ssure you that contributions to our research efforts are frequently made by producers and often represent the final financial push required for success. Such research contributions by private individuals are usually from the more affluent farmers and ranchers, the ones that can afford such generosity.

An economic study performed in California indicated that not only has such financial support of agricultural research by private groups and individuals been substantial, but that the time lag between the initial phases of the project and the actual accomplishment of the technological advancement, has been shortened considerably through the use of these additional funds.[8]

"Much of the work performed in argricultural experiment stations is subsidized by either industry or government. Research on minor crops may well lag behind other research programs unless some minimum industry support is received to enable purchase of needed equipment, materials and labor inputs.

"It would appear logical that given agricultural experiment station research with the minimum backing, then mechanization will be developed sooner or later regardless of industry financial support. At this point, the industry interest is then one of assuring the 'sooner' development rather than the 'later.' Additional financial support would be directed at compressing the probability function to the left, or increasing the probability that the research success would be achieved in a certain number of years or less."

It would be easy for me to claim, at this point, that all the spectacular advancements made in agricultural productivity have been solely due to the university and government achievenments, but this would not recognize the major stumbling block to technological progress—adoption of new technology. Scientists at the institutions and in the research laboratories can experiment and evolve new concepts, techniques and improved varieties. Our extension services then must take this new information out into the field to the producer and show him how to use it. But it requires the cooperation, the field testing, the sacrificing in time and money of the farmer and rancher that produces results and finally develops the new breeds and the modern types. During last year, for example, the Texas Agricultural Extension Service had the cooperative efforts of producers on 4,486 different field demonstrations, of which 1,283 dealt directly with livestock, breeding or feeding.

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[6] *A National Program of Research for Agriculture,* joint publication of the Association of State University and Land Grant Colleges and the U.S. Department of Agriculture.

[7] *Value Line Selection and Opinion.* Vol. XXIV, No. 44, Part 11, August 15, 1969.

[8] Samuel H. Logan, "Evaluating Financial Support of Research Programs," *Journal of Farm Economics,* February 1964.

AGRICULTURE NEEDS OUTSIDE CAPITAL FOR DEVELOPMENT AND EXPANSION

Agriculture is not a self-supporting industry, It requires huge quantities of capital, particularly when we consider the amounts needed to build up a breeding herd or to develop an improved crossbreed.

Fortunately, for us, the tremendous sums of capital required to experiment with new breeds and types has been available in the United States. In many foreign countries, for example, the government is relegated this chore because of the expense and the poor returns on investment. Our livestock producers have been blessed with a realistic Congress which, many years ago, provided some measure of relief for such individuals through somewhat less stringent accounting procedures. The result has been a livestock development in this Nation that far exceeds any other country in the world.

This requirement for high quantities of capital in cattle breed development is emphasized in the Yearbook of Agriculture 1968, issued by the U.S. Department of Agriculture. In a discussion of hybrid vigor and how this was used by corn breeders and later chicken and swine breeders, the author states:

"But cattlemen did not follow their lead immediately.

"One good reason for this lag was that cattle breeding stock represents a high investment because much time passes before a new generation reaches breeding age. So, it is quite expensive to experiment with new cattle breeding systems."

Yet, this did not discourage livestock producers and today United States beef cattle are among the world's most desired types. This expanded size of the market for beef breeding herds has added a new dimension to the capital problem. As Governor Connally has said, the United States is now a major exporter of beef breeding cattle. This exportation of beef breeding cattle offers an extremely favorable situation for the United States, in that it represents a commodity that is exported for cash, and does not have to be subsidized under any direct government program. At the same time, the good will established with these developing countries seems to be far more lasting than that produced with any other agricultural export, probably because such animals really represent years of research and development. Secretary of Agriculture, Orville L. Freeman wrote in The Yearbook of Agriculture 1968:

"But American agriculture is also the world's biggest "storehouse" and research 'factory' for agricultural knowledge. Exporting this knowledge to improve farm production in food-short countries can contribute immensely to world stability and peace—and to the eventual entry of the entire free world into the age of abundance."

Governor Connally mentioned that the innovators of the agricultural community are the utilizers of the latest technological developments, the experimenters of new breeds, and the land developers. Land clearing, stock pond establishment brush control and similar methods of increasing the efficient use of the land are sound management practices for the progressive manager.

The serious consideration here is the diametrically opposed positions which seem to be evolving in the different branches of the government. During 1967 alone, for example, $7 million was spent by the USDA in cost-sharing brush control work with farmers and ranchers of this country. In that same year, slightly over $14 million were expended on cost-sharing stock pond and agricultural reservoir construction. For another branch of the government to now contest, in effect, the legitimacy of these expenditures as a deduction, seems quite inconsistent. Certainly, such improvements add to the productivity of the land and probably to its net worth, but unfortunately in some isolated cases the value is actually decreased since the recreational value is lowered. Likewise land which is left unattended or overgrazed, can easily be lost to brush and erosion, thus lowering its productive value.

The Budget of the United States Government

Fiscal Year 1969 eloquently states the purpose of these cost-sharing programs in this passage:

"This program is designed to encourage conservation by sharing with farmers, ranchers, and woodland owners the cost of carrying out approved soil-building and soil-and-water-conserving practices. These are practices which farmers generally would not perform to the needed extent with their own resources. The rate of cost-sharing averages about 50% of the cost. Cost-sharing may be in the form of conservation materials and services or a payment after completion of the practice.

"Conservation measures offered include those primarily designed to establish permanent protective cover, improve and protect established vegetative cover, conserve and dispose of water, establish temporary vegetative cover, temporarily protect soil from wind and water erosion, and provide wildlife and beautification benefits.

These programs are designed to give technical assistance and aid the conservation operations of the Soil Conservation Service. During the fiscal year 1969, budget recommendations for these services were $203 million. Throughout the federal budget recommendations it is repeatedly emphasized that such cost-sharing assistance is necessary to continue the long term practices that prevent irreparable damage to land resources and that would not be applied if it were not for federal assistance.

If any doubt still exists that agriculture requires outside capital, it can be dispelled by the recognition that even the government has found it necessary to provide funds to agriculture through several major rural programs:[9]

"The Administration conducts two capital investment programs: (a) the rural electrification program to provide electric service to farms and other rural establishments; and (b) the rural telephone program to furnish and improve the telephone service in rural areas. Funds for making repayable loans are borrowed from the Secretary of the Treasury.

"1. *Rural electrification.*—This capital investment program is financed through loans which bear 2% interest and must be repaid within a period not to exceed 35 years. Loans are also made for shorter periods at 2% interest to electrification borrowers to be reloaned to their consumers for the purpose of financing the wiring of premises and the acquisition and installation of electrical and plumbing appliances and equipment, including machinery.

2. *Rural telephone.*—This capital investment program is financed through loans which are made for the purpose of financing the improvement, expansion, construction, acquisition, and operation of the telephone lines and facilities or systems to furnish and improve telephone service in rural areas. The loans bear 2% interest and must be repaid within a period not to exceed 35 years.

Financing farming and rural housing.—Loans of the Farm Credit Administration through the Federal intermediate credit banks for cooperatives are primarily to help finance agricultural production and marketing.

These extremely low rates of interest, and long payment periods provided by government lending emphasized that capital for such agricultural development is not really available even from outside sources.

SUMMARY

Agriculture, in the United States today, is dynamic and growing. In my own State, Texas, agriculture provided the market with almost $3 billion worth of products, during the past year. Except for crude oil and gas, agriculture brings to the State its largest source of income.

This agricultural growth, however, has not just happened. It was a result of a number of significant factors—development of new technology, education and promotion, the action programs of both the Federal and State Departments of Agriculture, availability of resources, and farmers and ranchers willing to adopt new practices. If agriculture is to remain strong, however, it must be guided through new treacherous cross currents—those of growing cities, shrinking resources, the continued price-cost squeeze, and general indifference from the urban-oriented society which it services.

The preliminary Texas water plan, for example, indicates that by 1980, 4½ million acres of cropland, about 3 million acres of which is highly fertile, will be removed from productive use. Most of this will be land destined to become water reservoirs to service the needs of the rapidly growing population centers as well as agriculture and the remaining million and a half acres will be required for urban development, highways, airports, etc. Our principal resource for agricultural production—land, is becoming scarce.

Our Texas Agricultural Experiment Station operates throughout the State. By virtue of its assigned responsibilities, it represents the focal point of coordination for all agricultural research in the entire State. It is important that this knowledge base be maintained in order to stimulate further agricultural development. Such efforts, however, must be supported by a massive, continuous research, education and extension program—a program combining all the diversi-

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[9] The Budget of the United States Government—Fiscal Year 1969.

fied and interdependent strengths of the scientific team expertise that we can muster.

But, the Experiment Station, the Extension Service and the entire University cannot succeed without the efforts and assistance of the dedicated individuals with the will and desire to try "a new idea." These innovators already realize that it may not lead to glory, nor riches, nor even maybe compensation—only self satisfaction that they have contributed.

Texas A&M University stands ready through its basic team to help meet this formidable and challenging task. Gentlemen, we ask not for your praise, but only for your cooperation in this effort.

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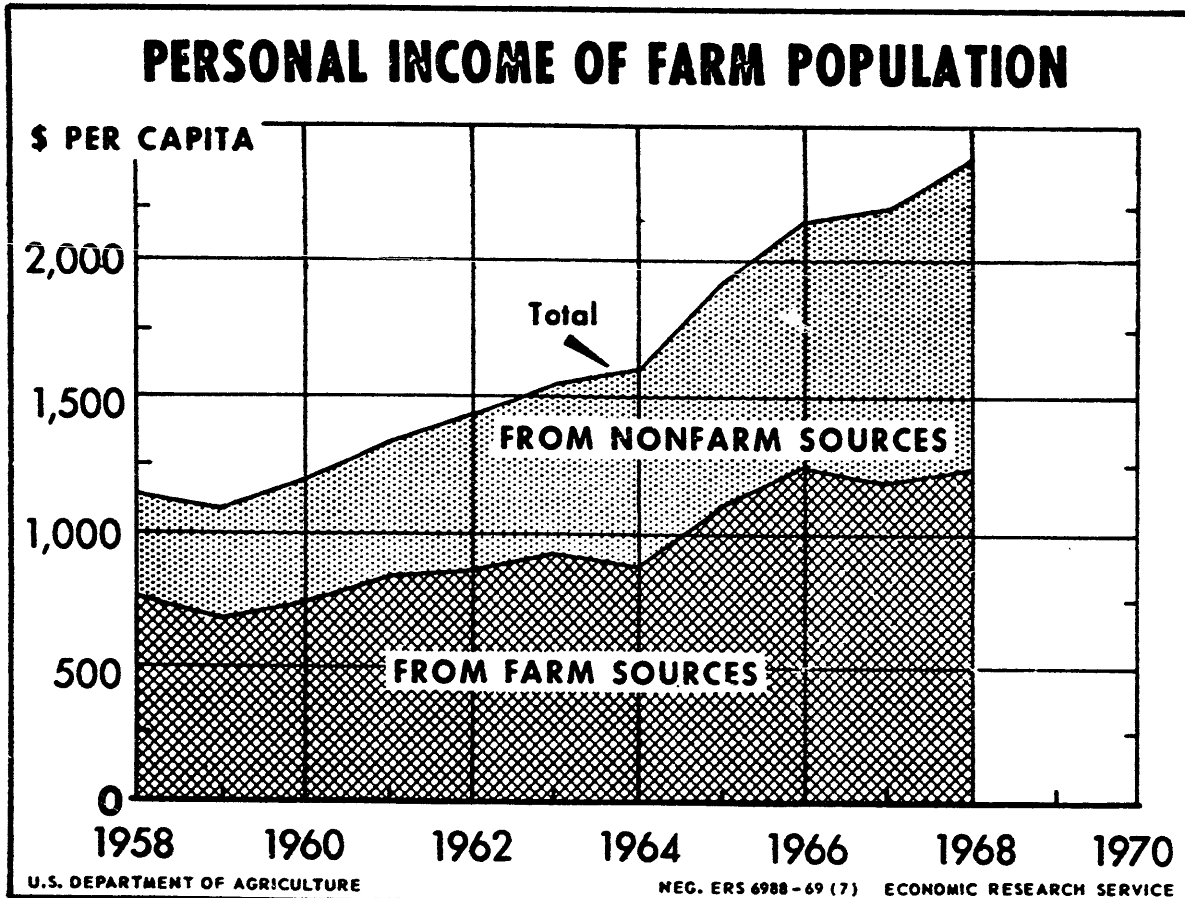

PERSONAL INCOME OF FARM POPULATION
$ PER CAPITA
2,000
1,500
1,000
500
0
Total
FROM NONFARM SOURCES
FROM FARM SOURCES
1958
1960
1962
1964
1966
1968
1970
U.S. DEPARTMENT OF AGRICULTURE
NEG. ERS 6988-69 (7)
ECONOMIC RESEARCH SERVICE

Figure 1

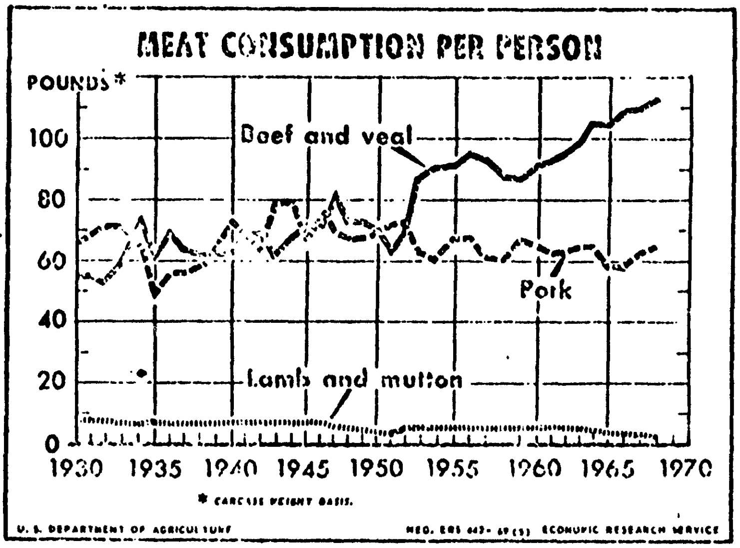


FIGURE 2

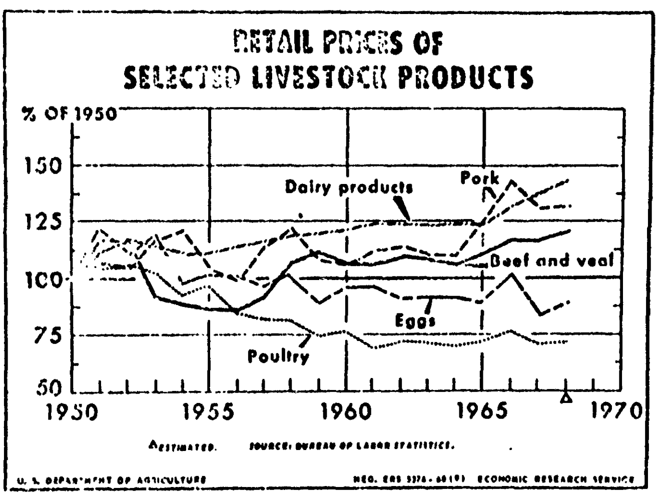
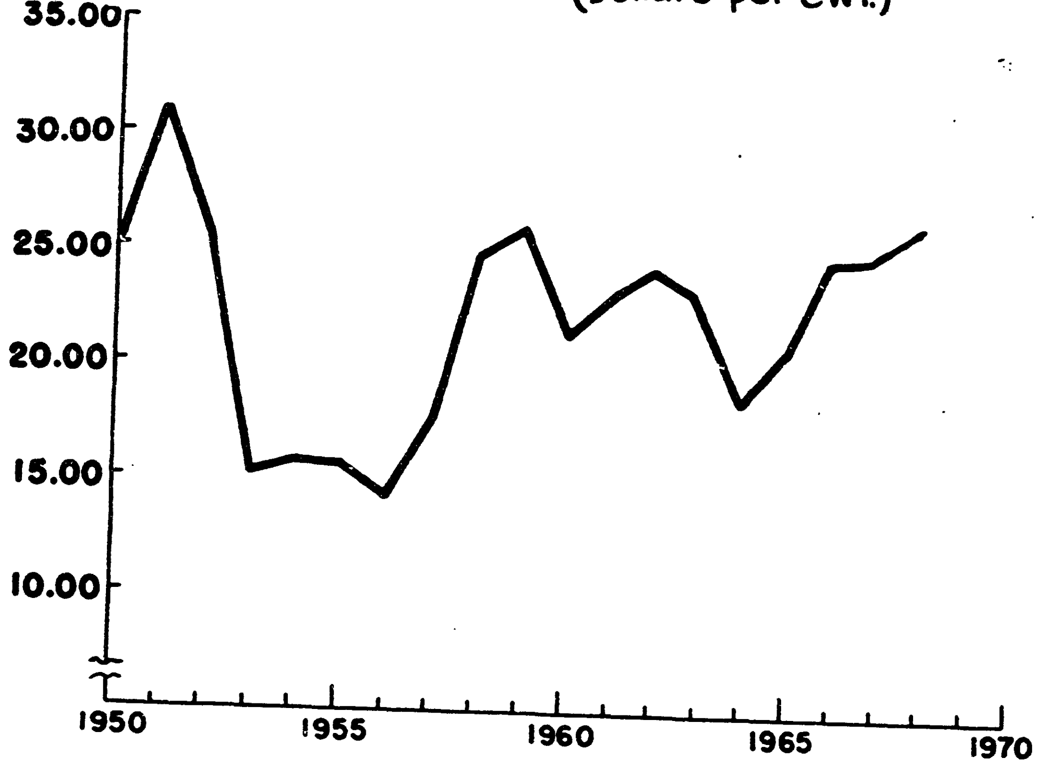


FIGURE 3

CALVES

Average Annual Prices Received by Texas Producers (Dollars per cwt.)



MONTHLY DATA

	1963	1964	1965
J	24.70	21.20	18.30
F	23.90	21.60	18.50
M	23.90	21.40	19.00
A	24.60	20.30	20.20
M	23.00	18.00	20.10
J	22.20	17.40	22.60
J	24.40	17.00	22.20
A	23.70	17.20	22.00
S	23.40	18.00	22.00
O	21.80	17.50	21.60
N	21.40	18.10	21.40
D	20.60	17.50	22.10

	1966	1967	1968
J	23.40	24.30	24.60
F	25.40	24.80	26.30
M	26.60	24.20	26.50
A	25.20	24.20	27.20
M	24.40	24.20	26.80
J	23.90	25.60	26.60
J	24.30	26.20	27.30
A	25.20	25.50	26.30
S	25.80	25.70	25.60
O	24.00	24.60	25.30
N	23.30	23.80	26.20
D	23.70	24.40	26.50

	1969	1970
J	27.20	
F	29.10	
M		
A		
M		
J		
J		
A		
S		
O		
N		
D		

FIGURE 4

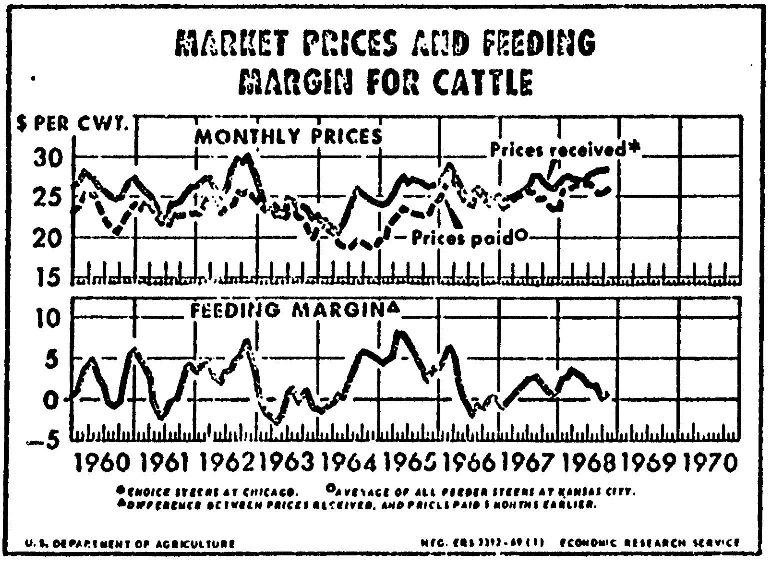

MARKET PRICES AND FEEDING MARGIN FOR CATTLE
$ PER CWT.
MONTHLY PRICES
Prices received*
Prices paid°
30
25
20
15
FEEDING MARGIN^
10
5
0
-5
1960 1961 1962 1963 1964 1965 1966 1967 1968 1969 1970
*CHOICE STEERS AT CHICAGO.
°AVERAGE OF ALL FEEDER STEERS AT KANSAS CITY.
^DIFFERENCE BETWEEN PRICES RECEIVED, AND PRICES PAID 5 MONTHS EARLIER.
U. S. DEPARTMENT OF AGRICULTURE
ECONOMIC RESEARCH SERVICE

FIGURE 5

Table 1 - Off-farm Income Exceeds Farm Product Value

Tenure of operator	Percent of farm with other income exceeding value of farm products sold	
	1964	1959
Total commercial farm	16.7	12.5
Full owners	24.4	16.9
Part owners	10.5	10.1
Managers	4.5	12.6
All tenants	9.3	7.2
Cash	16.4	13.5
Share-cash	4.2	5.1
Crop-share	8.1	6.5
Livestock-share	4.6	5.6
Other	20.7	10.9

Table 2 - Proportion of farm-operator households having income from off-farm sources

Region	Percent of farms having income from off-the-farm sources exceeding value of farm products sold		
	1964	1959	1954*
United States	38.7	35.8	29.8
North	30.1	28.1	23.1
South	47.4	43.2	34.6
West	41.4	39.5	35.5

* Alaska and Hawaii not included

Table 3 - Farm operated households having off-farm income exceeding the value of farm products

Value of farm Products sold	Percent of farms with other income exceeding value of farm products sold			
	1964	1959*	1954*	1950*
Total	38.7	35.8	29.8	29.1
Under $2,500	76.0	62.5	46.6	43.0
$2,500 to $4,999	33.0	27.2	12.6	10.2
$5,000 to $9,999	9.8	12.6	6.4	5.3
$10,000 or more	1.1	6.5	4.5	4.3

* Alaska and Hawaii not included

The CHAIRMAN. The next witness will be Mr. George S. Dillon, on behalf of the Manufacturing Chemists Association.

STATEMENT OF GEORGE S. DILLON ON BEHALF OF MANUFACTURING CHEMISTS ASSOCIATION

Mr. DILLON. Mr. Chairman, and members of the committee, my name is George Dillon. I am president of the Air Reduction Co., Inc. I am appearing on behalf of the Manufacturing Chemists Association. Our member companies produce about 90 percent of the basic industrial chemicals manufactured in the United States.

The chemical industry itself contributes about $46 billion to our gross national product and employs more than a million workers.

We have submitted a written statement commenting on 11 different aspects of the House bill. I would like to spend a few moments with some remarks on the items we consider most significant.

Our primary concern is with the drastic increase in corporate taxes imposed by the House bill.

This increase is a major cause of the imbalance referred to by the Secretary of the Treasury before this committee when he stated that the bill was "weighted in favor of consumption to the potential detriment of the Nation's productive investment" and that such imbalance "could impede the economic growth in the years ahead by curtailing the incentive to make productive investments."

The Treasury Department has estimated that the repeal of the investment credit provisions plus the so-called reform measures would add $4.9 billion to corporate taxes, an increase of some 16 percent.

The funds to pay these taxes must be raised by corporations either through price increases or by a reduction in their capital expenditures. Either alternative is extremely undesirable. The price increases would have an immediate and obvious inflationary effect.

The harmful effect of reducing capital expenditures on inflation is perhaps a little less obvious, but in the long term it is greater than price increases.

The most important contribution that we in the private sector can make in controlling inflation in this country is to produce an ever increasing supply of goods at lower unit costs.

This contribution can't be made unless adequate funds are available for reinvestment in our productive facilities. This bill would drain off such funds and seriously impair our ability to make this important contribution to a stable domestic economy.

The proposed increases have another adverse side effect: They would reduce our ability to compete at home and abroad with foreign producers. Today our foreign competitors continue to enjoy their traditional lower wage rate advantages but, in addition, they have productive facilities as efficient as ours. In many instances these facilities are subsidized by tax concessions granted by their government.

In summary, we believe that the corporate tax increases proposed in the House bill would weaken our efforts to control inflation domestically, and undermine our competitive position in the international marketplace with unfortunate consequences to the U.S. balance of payments.

We endorse strongly the proposal of the Secretary of the Treasury that corporate tax rates be reduced to help offset the impact of the repeal of the investment credit.

I would now like to comment on some specific provisions of the House bill.

Real estate depreciation, section 521.—This provision would limit the depreciation that may be claimed on real property. We recommend that it not be applied to industrial properties such as factories, warehouses and so forth. We suggest that accelerated depreciation continue to be allowed, but if such depreciation is later recaptured through a sale of the property it be taxed as ordinary income, as is presently provided in section 1245 of the code covering sales of personal property under similar circumstances.

Capital gains rates for corporations, section 461.—We see no valid reason to increase from 25 percent to 30 percent the tax on corporate capital gains. We would recommend that capital gains be taxed in the same manner to corporations as to individuals, namely the full rate on one-half of the long-term capital gain.

The computation of earnings and profits, section 452.—This particular provision is intended to prevent tax-free distributions of dividends by certain domestic corporations, particularly in the real estate and public utility businesses. We suggest that it be made clear that it does not apply to foreign subsidiary corporations, where it would impose a substantial and, we understand, a completely unintended hardship.

Moving expenses, section 231.—This provision broadens the moving expense deduction to include the expenses of house hunting and the sale and purchase of houses. We support the new rules but believe that the $2,500 limitation is completely unrealistic. Actually $2,500 barely pays the various fees and other expenses involved in selling one medium-priced house and buying another one, and certainly wouldn't cover a good many of the other incidental expenses such as temporary quarters during a period when the employee is hunting for a new house.

Furthermore, the bill contains another limitation which provides that the moving expense provision will not apply unless the new place of business is at least 50 miles farther from the old house than was the old place of business. Many companies are moving their operations from the congested cities into the suburban areas. The employees of such companies frequently have to move because of the lack of public transport between their old house and the new company location, even though the distance of the trip is not 50 miles longer. We think the 20-mile limitation contained in present law, which is proposed by the Secretary of the Treasury, is more realistic and completely adequate to provide whatever safeguards are required in this regard.

Deferred compensation, section 331.—We recommend that your committee adopt the proposal of the Secretary of the Treasury with respect to this provision; namely, that it be deleted from the bill pending a completion of the Treasury study of this extremely complex subject.

Taxation of lump-sum distributions from pensions or profit-sharing trusts, section 515.—This provision would tax such distributions to the extent attributable to employer contributions as ordinary income rather than capital gains, with some relief through an extremely complicated averaging device. We oppose enactment of this provision.

The current rules, we believe, provide a very simple and equitable basis for taxing as capital gains lump-sum distributions accrued to an employee in pension and profit-sharing trusts over many years of employment, and these provisions should be continued.

I would like to make a final comment on one subject not covered in our formal statement. MCA plans to submit a separate statement to your committee opposing legislation which would make nondeductible treble damage payments. In the event that this subject is considered during these hearings, we respectfully request that our statement concerning this matter also be considered and included in the record.

Gentlemen, that concludes my testimony.

The CHAIRMAN. Thank you very much, sir.

(George S. Dillon's prepared statement follows:)

STATEMENT OF GEORGE S. DILLON ON BEHALF OF THE MANUFACTURING CHEMISTS ASSOCIATION

SUMMARY

1. Corporate rate reduction

The repeal of the investment tax credit and various reform provisions contained in H.R. 13270 would increase the tax burden of corporations by $4.9 billion. This increased burden would affect the ability of corporations to meet their present productivity and employment levels, would lead to increased prices, and weaken the competitive position of U.S. industry in international trade. To offset the adverse effects of this increased tax burden, a compensatory corporate tax rate reduction is recommended.

2. Deferred compensation (section 331)

The proposed new rules for taxation of deferred compensation are unnecessary and unsound and would lead to extremely difficult compliance and auditing problems. We recommend deletion of this provision as proposed by the Secretary of the Treasury.

3. Fifty-percent maximum rate on earned income (section 803)

We endorse the concept of placing a maximum tax rate of 50% on earned income, and recommend that deferred compensation, bonus awards, and all payments attributed to either qualified or non-qualified employer plans which are considered as ordinary income be treated as earned income for the purposes of this section.

4. Restricted stock (section 321)

We recommend that the controlling date for transfers under pre-existing plans be changed from February 1 to April 1, 1970, to give corporations more time to accommodate to this provision.

5. Total distributions from qualified pension, etc., plans (section 515)

We believe the current rules provide a relatively simple and equitable basis for taxing lump sum distributions accrued to an individual over a substantial portion of his employment career and recommend against the change proposed in Section 515.

6. Moving expenses (section 231)

The $2,500 limitation on deduction of certain moving expenses is considered inadequate; the removal of this limitation is recommended.

The bill would change the distance test to qualify for a moving expense deduction from 20 to 50 miles. We recommend retention of the 20 mile test as proposed by the Administration.

7. Effect on earnings and profits (section 452)

The amendment proposed in this section would create substantial hardships in the corporate foreign income area. We recommend that this section be modified to make clear that its provisions do not apply to the computation of earnings and profits of foreign subsidiary corporations.

8. Real estate depreciation (section 521)

We recommend that the new, more restrictive rules on depreciation provided in this section *not* apply to industrial real property, but that full recapture of depreciation be provided for to the extent of gain on later sale of the property.

9. Foreign tax credit (sections 431 and 432)

We recommend: (a) extension of the foreign tax credit to all situations where the U.S. imposes Federal income tax on undistributed profits of foreign corporations under Subpart F; (b) the reduction of the 50% stock ownership test in section 902(b) to 10%; (c) the extension of the foreign tax credit to foreign corporations which are below the second tier and are connected by a 10% stock ownership.

10. Alternative capital gain rate for corporations (section 461)

We recommend against the increase from 25% to 30% proposed in section 461 relating to the alternative capital gain rate for corporations.

11. Natural resources (section 501)

As a reduction of percentage depletion rates would undoubtedly lead to higher costs to the chemical industry for petroleum feedstocks and mineral raw materials, we recommend retention of the existing percentage depletion rates for natural resources.

STATEMENT

Mr. Chairman and members of the committee, my name is George S. Dillon. I am President of Air Reduction Company, Incorporated. I am appearing before you today on behalf of the Manufacturing Chemists Association, a non-profit trade association of 174 United States company members representing more than 90 percent of the production capacity of basic industrial chemicals within this country. In addition, our companies carry on extensive international operations throughout the world.

Based on a detailed analysis of the provisions of H.R. 13270, we find that many of its proposals would, if enacted, have a significant impact upon the U.S. chemical industry. We particularly appreciate, therefore, the opportunity to present to this Committee the Association's views on this comprehensive tax measure.

Corporate rate reduction

The recently passed House tax measure, after full implementation, provides for a net revenue loss of $2.4 billion. Although entitled "The Tax Reform Act of 1969," its major impact represents a redistribution of current tax obligations from individuals to business. The most significant items are repeal of the investment credit, which would increase revenues by $3.3 billion and an individual rate reduction of $4.5 billion. The reform provisions contained therein pale into insignifiance as compared to the economic implications of an additional burden to corporations estimated by the Treasury to be $4.9 billion (an effective tax rate increase of approximately 16%) and a reduction of individual obligations by $7.3 billion. The reports accompanying the proposed bill give no indication of serious consideration of the economic and inflationary impact which these shifts might foment. Assistant Secretary of the Treasury, the Honorable Edwin S. Cohen, in his statement to your Committee on September 4th, has already cautioned against this approach when he stated:

"The resulting shift in emphasis of this magnitude from investment to consumption is in our judgment inadvisable."

Without detracting from the long range benefits to be derived from general rate reductions, fairness and the economic well-being of the United States require that this bill be amended to provide for a corporate tax rate reduction before consideration is given to any general rate reductions. Since the increased burden placed on corporations from repeal of the investment credit represents almost 10 percent of the total revenues from corporations, an equivalent rate reduction seems an appropriate first step. Thereafter, if the Congress determines that it is fiscally possible to provide general rate reductions, it is recommended that such reductions also apply uniformly to corporations and individuals alike.

Assistant Secretary Cohen has endorsed such a proposal for inclusion of corporations in any general rate reduction in the program he submitted to your Committee wherein he stated:

"The program also calls for a corporate rate reduction ultimately reaching two percentage points—relief of the same general magnitude as the individual rate reductions."

The rules prescribed by your Committee do not permit discussion at this time with respect to the provision in H.R. 13270 which could, if enacted, result in repeal of the investment credit. Nevertheless, in considering equitable economic treatment for corporations, it must be pointed out that the 88th Congress had previously incorporated the benefits derived from the investment credit into its determination of an equitable relationship of tax rates for individuals and corporations. First recognizing that the most important change made at that time was in the individual's income tax rate reduction, the Executive Branch, the House Ways and Means Committee and your Committee all pointed out that the disproportionately lower $2.2 billion tax cut for corporations had to be viewed in connection with the reduction provided by Congress in the 1962 Revenue Act in the form of an investment credit and the reform provided in the depreciation guidelines. Cognizance was taken of the fact that together corporations were provided with a tax reduction of approximately $4.5 billion.

Had corporate taxpayers not been assured that the investment credit would be a permanent feature of the tax structure greater consideration would have been given to a larger corporate rate reduction at that time.

Corporations have also been disproportionatley burdened in other ways. Both the 1964 and 1966 Revenue Acts included provisions for the earlier payment of corporate income taxes so that the tax reductions were significantly minimized. More recently, in the enactment of the 10 percent surcharge, corporations were again subjected to unequal treatment in that the surcharge was applied from January 1, 1968, whereas individuals were only affected from April 1, 1968. In addition, your attention is invited to the significant increase in the corporate tax burden in the future stemming from the elimination of the faster methods of depreciation for real estate in the bill before you—when fully effective, approximately $750 million will be added to the corporate tax bill.

Serious consideration must be given to the economic impact of the proposals embodied in H.R 13270 which would significantly increase the effective rate of tax for corporations. A substantial shifting of tax burden as currently proposed in H.R. 13270 will adversely affect the ability of corporations to continue to meet their present productivity and employment levels. There is also widespread agreement between economists and experts on taxation that, to at least some degree, corporate income taxes are pushed forward into prices. An increase in the effective rate of corporate taxes will, therefore, further fuel the inflationary conditions now existing, creating a most undesirable situation compared to the deflationary effect that is so urgently needed currently and which might be achieved through a lessening of pressure on prices if the corporate tax rate were reduced.

The increased corporate tax burden proposed in this bill would place American industry at a serious disadvantage in competing with foreign industry both at home and abroad. Foreign producers have historically had the competitive advantage of cheap labor which we managed to counterbalance through more efficient productive capacity. But foreign producers now have modern machines also, as well as low-wage labor, and their governments grant tax credits to encourage development of the most up-to-date, efficient production facilities. Removal of the investment credit without some compensatory tax relief would, we believe, drastically weaken the competitive position of American industry with unfortunate consequences to our internal economy and to our balance of payments.

Under the circumstances, it is not only equitable but economically essential that consideration be given to a reduction of the corporate tax rate to offset the adverse effects of the repeal of the investment credit. Thereafter, and to the extent fiscally possible, any general rate reduction considered by your Committee should, as recommended by the Treasury Department, include corporations as well as individuals.

Deferred compensation—Section 331

Section 331 of H.R. 13270 provides that deferred compensation exceeding $10,000 will be taxed at the rate applicable to the year of receipt or the year in which such payments are deemed earned, whichever is higher. The 50 percent maximum rate of tax on earned income provided in Section 802 of the bill is specifically made non-applicable to any deferred compensation payment. Thus, a taxpayer receiving deferred compensation would pay the highest possible tax on such compensation.

This proposed provision with respect to deferred compensation appears to us to introduce an entirely new principle of taxation for which there is no precedent and for which no need has been demonstrated.

The House Report states that under arrangements now in effect between employers and employees, some high bracket employees are permitted to defer the receipt and taxation of part of their current compensation until retirement when they presumably will be in lower income brackets. However, the provision in the House bill would seem to go far beyond the indicated objection by indiscriminately covering typical corporate deferred compensation plans which have been in existence for many years and which serve a valid corporate business purpose in attracting and holding employees by giving them a greater stake in the company in which they work. These plans typically cover not just top executives, but hundreds of employees reaching down into the lower levels of management. In most cases, employees are members of such plans for significant portions of their careers. The tax savings, if any, from the deferment of compensation are minimal. There is no guarantee that deferred compensation will, in fact, be taxed at a lower rate when received than when it was earned or credited to an employee and instances where exactly the opposite is true are numerous. In many cases employees have no control over deferment or non-deferment of the compensation. The necessity for penalizing such taxpayers has not been demonstrated.

From the technical standpoint, the provision would introduce entirely new concepts which would lead to extremely difficult compliance and auditing problems. Under career plans with payout of deferred compensation after retirement, 1970 tax rates would become applicable to compensation received well into the twenty-first century. As pointed out by Assistant Secretary of the Treasury Cohen in his testimony before your Committee, the annual accounting concept underlies our entire tax system. This provision would modify both the cash method of accounting and the annual accounting period concept.

We endorse the Secretary's statement and urge that this provision in the House bill be deleted. If any reform is needed in this area, we agree that considerable further study is required before the nature and extent of such reform can be properly identified.

Fifty-percent maximum rate on earned income—Section 803

We strongly endorse the concept of placing a maximum tax rate not in excess of 50 percent on earned income as a tax relief measure for those whose wages, salaries, professional fees and compensation for services are subjected to extremely high tax rates. Large salaries presently paid corporate executives stem in part from the extremely high individual income tax rates and a provision such as this will significantly eliminate tax considerations from salary negotiations.

We note that deferred compensation is specifically excluded from the definition of earned income. However, no definition is given of deferred compensation. In this regard, we feel that bonus awards paid during employment, whether or not in more than one installment, and all payments attributed to either qualified or non-qualified employer plans which are considered as ordinary income should be treated as earned income and entitled to the benefits of Section 802.

Restricted stock—Section 321

Section 321 of the House bill would change the taxation of gain on stock given to employees subject to restrictions However, under the transition rules the new treatment will not apply to property transferred "(3) . . . before February 1, 1970, pursuant to a written plan adopted before July 1, 1969 . . ."

This transition rule recognizes the need of permitting the granting of restricted stock under existing plans for executive performance in the taxable year 1969. However, it is submitted that the period from January 1 to February 1, 1970, is too short a period for a company with worldwide operations to receive audited statements for 1969 and take actions necessary to granting awards and issuing restricted shares. Accordingly, it is recommended that the controlling date for transfers under pre-existing plans be changed from February 1 to April 1, 1970.

Ordinary income treatment of portion of lump-sum distributions from pension and profit-sharing trusts—section 515

The bill would remove the capital gains tax on lump sum distributions from pension and profit-sharing plans in the case of employer contributions made after

1969 which would be taxed as ordinary income with some relief through an averaging device. This new treatment would not apply to amounts already in employee's accounts.

The development of private pension and savings plans has been encouraged by the Congress for many years and should continue. These plans provide economic security for an employee's retirement, disability, unemployment or death, through private savings over and above Government social security which was intended to provide only an average level of subsistence. Favorable tax laws have stimulated the growth of these plans and should be continued in order to provide an incentive for self-reliance, individual initiative and personal thrift.

Current law, which provides for capital gains treatment on such lump sum distributions, was adopted as a solution to the problem of a taxpayer receiving an amount in one taxable year which had been accrued over his entire career with his employer. We believe the current rules provide a relatively simple and equitable basis for taxing lump sum distributions accrued to an individual over a substantial portion of his employment career and should be continued. The House proposal, if enacted, will add many more complexities to the tax law. Instead of paying a simple tax in the year of receipt of a lump sum distribution, an employee will have to divide up his distribution as between the amount accrued through 1969, amount contributed by his employer, and, as to future accumulations, go through numerous steps to compute his tax. These complications will be burdensome to the employee and will also force upon the employer additional and costly record keeping.

The bill also amends Section 217(c) of the Internal Revenue Code which, in essence, provides that the taxpayer's new principle place of work must be at least 20 miles farther from his former residence than was his former place of work, or if he had no former principal place of work, at least 20 miles from his former residence. Under the new provision the 20 mile test is increased to 50 miles. We believe this test is unduly restrictive and support the Treasury Department's similar position on this matter.

We would like to point out that it is not the practice of most employer companies to reimburse employees who relocate solely for their own convenience. Reimbursement is generally limited to those cases where the employer has taken some action which makes the employee's former residence unsuitable. For example, assume an employer is located in a metropolitan area such as New York City. That employer will undoubtedly have employees commuting from Long Island, Westchester County, Connecticut and New Jersey. Should the employer then move his office to New Jersey, it is quite likely that the employees resident in Connecticut, Long Island, and Westchester will either have to move to New Jersey or seek new employment, evven though the new principal place of work might be less than 50 miles farther from his former residence than was his former principal place of work. Accordingly, we would urge you to modify the House provision and continue the 20 mile test now contained in Section 217 of the Internal Revenue Code as recommended by the Administration.

Although it appears that no withholding of taxes will be required on these amounts if it is reasonable to believe that they fall within these provisions, we urge that this be clarified so that there is no doubt but that withholding is not required.

For the above reasons, we oppose the proposals in the House bill relating to distributions from pension, stock bonus, and profit-sharing plans.

Moving expenses—Section 231

Section 231 of H.R. 13270 provides a new moving expense deduction for house-hunting trips, temporary living expenses prior to locating a new home, and for the expenses of selling an old home or buying a new one, subject to a ceiling of $2,500 and a $1,000 limitation on expenses relating to house-hunting and temporary living expenses. The changes proposed by the House recognize the inequity of taxing an employee on reimbursed expenses that he would not otherwise incur absent a request on the part of his employer to transfer from one location to another, but regrettably only provide partial relief from the inequities existing in current law.

A review of the proposed bill, particularly as it relates to the limitation in reimbursements, reveals that most employees who are required to relocate will only achieve partial relief since the $2,500 limitation contained in the bill is clearly inadequate in the case of most moves. For example, assume an individual, upon relocating, sold a $25,000 house in his old location and bought a $25,000 house in a new location. The qualified residence sale, purchase, or lease expenses in this case (lawyer's fee, real estate agent's commission, escrow fee, appraisal fee, title costs, etc.) would be close to the $2,500 limitation, with the result that any reimbursement for house-hunting trips and temporary living expenses would constitute taxable income. We would urge that the dollar limitations contained in the bill be eliminated, providing the individual involved is reimbursed for expenses qualfying under this section and has to account for such expenses to his employer.

Effect on earnings and profits—section 452

This provision amends § 312 of the Internal Revenue Code to require every corporation to use the straight-line method of depreciation for purposes of computing its earnings and profits, regardless of the fact that it may have used accelerated methods permissible under § 167 in computing its taxable income. Under present law, some corporations have been able to use the excess of accelerated depreciation over straight-line depreciation to reduce their earnings and profits to such an extent that they have been able to make tax-free distributions to their shareholders. Such distributions are said to be "an improper tax benefit to shareholders which is generally unrelated to the purposes for which accelerated depreciation deductions are made available to corporations." (H. Rep. No. 91–413, Part 1, 91st Congress, 1st Session, page 134.) The amendment, if adopted, would end that practice.

The proposed amendment, however, creates substantial and apparently unintended hardships in the corporate foreign income area. The denial of the use of accelerated depreciation in the computation of earnings and profits of a foreign corporation will increase the recomputed earnings and profits of foreign corporations for foreign tax credit and minimum distribution purposes and will reduce the amount of the foreign tax credit available to the U.S. parent corporation under § 902 and § 960 with respect to dividend distributions from the foreign corporation. It will also substantially increase the burden of meeting the minimum distribution requirements for corporations which have made that election under § 963.

In addition, the proposed amendment unfairly penalizes the use by a U.S. corporation of a foreign corporation in operating outside the U.S. as compared to the use by the U.S. corporation of a foreign branch. For example, assume a U.S. corporation operates through a branch in Foreign Country A. Assume further that the provisions of A's income tax laws with respect to depreciation allowances and rates of tax are the same as in the U.S. and that an accelerated depreciation method is used. The foreign source taxable income of the branch (which limits the amount of foreign income taxes available as a credit against the U.S. tax) and the foreign tax credit are unaffected by the proposed amendment. On the other hand, where the U.S. corporation operates abroad through a foreign corporation, the proposed amendment would increase the earnings and profits of the foreign corporation and thereby reduce the amount of "deemed paid" credit to which its parent would otherwise be entitled, under present law, to offset against the U.S. tax otherwise payable on the dividend.

Because the purpose of the proposed legislation is to prevent tax-free distributions to shareholders, § 452 should be modified to make clear that its provisions do not apply to the computation of earnings and profits of a foreign corporation less than 50 percent of whose gross income is effectively connected with the conduct of a trade or business in the U.S.

We also urge that serious consideration be given to an approach which would only apply this new principle in situations where the distribution would be tax-free because of the use of the accelerated methods of depreciation. In other words, these new rules would only be applied when the corporation does make a tax-free distribution and not before.

Real estate depreciation—Section 521

Section 521 of H.R. 13270 generally limits the depreciation that may be claimed by a taxpayer on buildings constructed after July 25, 1969, to an amount not exceeding 150 percent of straight-line depreciation and provides that the gain on the sale of depreciable real property after July 24, 1969, will be treated as ordinary income to the extent that accelerated depreciation taken after this date is in excess of allowable straight-line depreciation. This proposed change in law is in response to Congress' valid concern with real estate transactions conducted by speculators which result in large ordinary deductions which offset ordinary income followed by a subsequent sale of the real estate at a time when the gain on the sale constitutes a Section 1231 gain entitled to the more favorable capital gains tax rates. The proposed changes also reflect the fact that the present tax treatment creates an environment favorable to frequent turnover of real estate and tends to discourage long-range stewardship and adequate maintenance of facilities and thus needs to be modified.

We are sympathetic with Congress' concern, but feel that the proposed solution is inadequate and, in fact, inequitable in many situations. There is little reason to apply these new rules to industrial real property—by which we mean factory buildings, warehouses, and similar structures used by a manufacturing concern in the operation of its business. Such property is not acquired for the purpose of generating tax-sheltered income, and its disposition is determined for reasons wholly apart from tax considerations.

We would strongly urge a simplified but tougher tax treatment for the gain on the sale or disposition of real property. This would be accomplished by applying the same recapture rules that Congress enacted in 1962 when it added Section 1245 to the Code, which provides that all depreciation claimed after the effective date of the legislation which is recaptured on sale receives ordinary income treatment. If real estate recapture provisions were to be revised to conform to the personal property recapture provision in § 1245, then it would be permissible to continue to use accelerated methods of depreciation, such as double declining balance and sum-of-the-years digits.

This proposal is advanced on the condition that more realistic guideline lives on buildings are provided by the U.S. Treasury Department. The guideline lives for buildings which the Treasury announced in 1962 are far less liberal than those generally available for machinery and equipment. In fact, in some cases, the building lives are actually longer than those lives provided in the outmoded and obsolete Bulletin F. In the past, Treasury officials indicated that the basic reason for this stringent treatment with respect to buildings is that they have been excluded from the full recapture provisions contained in Section 1245. We believe that, with the modifications suggested in this presentation, Government revenues would be adequately protected and more equitable treatment will be available for the true investor in real estate; industrial, commercial, and residential.

We would also strongly suggest that your Committee consider removal of the reserve ratio test from the guideline rules promulgated by the U.S. Treasury Department. Adoption of such a measure will eliminate complications in the depreciation area and will go a long way toward removing depreciation controversies between the Government and taxpayers at little or no loss of current revenues.

Foreign tax credit—Sections 431 and 432

H.R. 13270 contains two provisions restricting the application of the existing foreign tax credit provisions (Sections 431 and 432) which bear vitally on the extractive industries. While this Association expresses no opinion on the rationale for, and the net effect of, these restrictions, we are concerned that this might be a step toward further changes in present law as it applies to other industries. In this regard, we wish to emphasize that there should be no changes in the application of the present foreign tax provisions which would violate or weaken the philosophy of "tax neutrality" underlying these provisions.

We note that the Treasury Department has suggested that foreign taxes in any country which exceed 60 percent of distributed income from such country (regardless of the source or character of such an income) should not be available as a credit against United States taxes on foreign income from other countries. This Association opposes any such limitation which militates against the presently recognized principle that a taxpayer can look at his foreign operations as a single unit, and, therefore, take into account all foreign income and income taxes for foreign tax credit purposes.

Furthermore, while this subject is under consideration, there are additional reforms which should be considered and adopted in the interest of a fair and equitable tax system.

This Association has urged over the past years that the law be changed so as to broaden the provisions of the Internal Revenue Code permitting foreign tax credits for foreign income taxes paid by foreign subsidiaries.

We specifically recommend:

(1) The extension of the foreign tax credit to all situations where the United States imposes Federal income tax on undistributed profits of foreign corporations under Subpart F; and

(2) The reduction of the 50 percent stock ownership test in Section 902(b) to 10 percent, and also the expansion of Section 902 to cover dividends received from earnings and profits of all foreign corporations below the second tier which are connected in a chain of corporations by a 10 percent or more stock ownership.

The Federal income tax law since 1918 permitted the portion of the United States income tax attributable to foreign income to be offset by foreign income taxes attributable thereto. In addition, since the early 1920's, foreign dividends received by a domestic corporation have received a tax credit determined ratably by the proportion of the earnings and profits distributed. This credit is allowed a domestic corporation under Section 902(a) only where the domestic corporation receiving the dividend owns at least 10 percent of the voting stock of the foreign corporation. A foreign tax credit is also allowed under Section 902(b) for foreign income taxes paid with respect to earnings ultimately received by the domestic corporation from a foreign corporation, 50 percent of whose voting stock is owned by the 10 percent owned foreign corporation. Thus, the foreign tax paid by the 50 percent owned subsidiary passes through its foreign parent corporation to the domestic corporation for foreign tax credit purposes.

(1) We believe that the 50 percent test is too high and that it should be reduced to 10 percent; and

(2) the foreign tax credit should be extended to foreign corporations which are below the second tier and are connected by a 10 percent stock ownership.

Turning now to Subpart F, every United States shareholder who owns directly or indirectly 10 percent or more of the combined voting power of all classes of stock of a controlled foreign corporation is subject to tax on his pro rata share of foreign base company income and the increase in investment in United States property of such corporation. Accordingly, a United States shareholder is subject to tax under Subpart F where there is a 10 percent or more direct or indirect stock owneship of a controlled foreign corporation.

Despite the requirement of current taxation on certain undistributed profits of indirectly owned controlled foreign corporations, there is no allowance for a foreign tax credit for foreign income taxes paid on those profits except in situations where a credit would be allowed had those profits been distributed. In other words, the foreign tax credit provisions were not extended to dovetail with taxing provisions of Subpart F.

The principal objection to broadening the stock ownership requirements for foreign tax credit purposes has been the administrative difficulties of checking the relevant facts necessary to prove the proper credit. However, in view of the recent extensive expansion of the information procurable by the Internal Revenue Service, there no longer can be a valid basis for objection on this ground. The Internal Revenue Service received under Section 6046 an information return from each United States person who owns 5 percent or more in value of stock of a foreign corporation. Moreover, since 1962 a United States shareholder owning directly or indirectly 10 percent or more of the stock of controlled foreign corporations in a chain has been taxed on the ratable portion of their Subpart F income. There should be no objection therefore, from an administrative viewpoint, for providing the appropriate foreign tax credit as we propose.

There can be no question as to the soundness of the foreign tax credit. It prevents in many situations a double income tax burden which would be penal in nature and which, in the long run, would ultimately result in the loss of United States private investment abroad. The foreign tax credit helps place United States business on an equal competitive basis with its foreign competitors. Theoretically, there is no reason for any limitation on the amount of stock which should be owned by the domestic corporation or one of its foreign subsidiary corporations before credit is allowed for the foreign income taxes paid with respect to distributed earnings.

In order to eliminate this potential double tax burden, many corporate managements endeavor to reorganize their foreign subsidiary structures for the purpose of simplification and in order to qualify their subsidiaries for foreign tax credit. This requires in many cases liquidations and reorganizations which fall within the ambit of Section 367 requiring prior clearance by the Commissioner of Internal Revenue before the exchanges can be considered tax-free. However, the Commissioner has taken such categorical positions under Section 367 that it is virtually impossible to obtain favorable decisions. The Manufacturing Chemists Association has made a study of the administration by the Internal Revenue Service of Section 367 and as a result has concluded that the administrative power of the Commissioner through the advance ruling requirements should be eliminated. In brief, the Manufacturing Chemists Association recommends that the question whether there is a plan having as one of its principal purposes the avoidance of Federal income taxes be left to the courts. We hope you will consider revising and liberalizing Section 367 requirements.

Alternative capital gain rates for corporations—section 461

Section 461 would raise the alternative tax rate on net long-term capital gains of corporations from 25 percent to 30 percent. The reason for this change is to provide a comparable increase in capital gains tax to that proposed with respect to individuals, since the capital gains rate for individuals would be eliminated—thereby raising the maximum capital gain tax above 30 percent.

We do not believe that it is necessary to raise the corporate capital gains rate to a comparable level. We believe that long-term capital gains should be taxed in the same manner as is applied to individuals—namely, a full corporate rate should be imposed on one-half of the long-term capital gain. It is inequitable to impose higher capital taxes at the corporate level when the distribution of these amounts will again be subject to tax as dividends. The establishment of a proper corporate tax should apply to the taxable half of net long-term capital gains.

This recommendation is consistent with the Treasury Department's proposal to return to a 25 percent basic rate. We do not subscribe to the alternative proposal of the Treasury Department to apply a 30 percent rate for gains exceeding $50,000.

Natural resources (percentage depletion)—section 501

The chemical industry consumes a substantial amount of petroleum derivatives and hard minerals in its chemical operations. Reduction of percentage depletion rates will result in higher costs to the chemical industry for these feedstocks and raw materials at a time when chemical product prices are severely squeezed. In addition, depletion allowances have helped give this country an adequate supply of energy products at reasonable prices, and reduction of these allowances would result in increased costs for these products. These cost increases would necessitate compensating price increases on the part of the chemical industry further contributing to the inflationary spiral.

For the foregoing reasons, the chemical industry believes that continuation of existing percentage depletion rates is in the national interest, and accordingly strongly urges that these rates not be changed.

Conclusion

Mr. Chairman, I wish to thank you and the members of this Committee for affording me the opportunity to present for your consideration the views and recommendations of the Manufacturing Chemists Association on the Tax Reform Act of 1969.

The CHAIRMAN. The next witness is Mr. Stanley R. Fimberg of Beverly Hills, Calif.

STATEMENT OF STANLEY R. FIMBERG, BEVERLY HILLS, CALIF.; ACCOMPANIED BY EDWARD WEINBERG, ATTORNEY

Mr. FIMBERG. Mr. Chairman, my name is Stanley Fimberg, I am a tax lawyer from Beverly Hills, Calif. I am joined here today by Ed Weinberg, an attorney with the firm of Wyman, Bautzer, Finell, Rothman, and Kuchel, Washington, D.C.

I appreciate the opportunity to appear before this committee to testify regarding provisions which I feel were poorly conceived and which are even more poorly applied because of the variety of technical deficiencies which appear therein.

I will limit my testimony today to just a general explanation of the things that I consider wrong with the provision. A more complete statement has been submitted.

To me the basic fallacy of the provisions, as a tax lawyer, is an attempt, in the name of tax reform, to create a provision which has in it inherent discrimination among various groups of taxpayers.

I know the Honorable Mr. Stanley Surrey appeared before this committee, and dismissed these discriminations in a paragraph, but I submit that they exist and I would like to point them out to the committee, and I submit they cannot be dismissed in a paragraph. I think the Treasury's feelings about these provisions is evident in that they have now asked that they not be supported.

Basically, the new section 221 would limit the interest deduction in a fashion where it would apply differently to taxpayers who are wage earners, taxpayers who have investment income, and taxpayers who are engaged in a trade or business.

I submit that the logic behind these differences is a little difficult for me to grasp, and I think maybe I could illustrate it best for the committee by giving an example of three different taxpayers all of whom were similarly situation except in the nature of earning their income and all of whom would be treated quite differently by the application of this provision.

For simplification I will refer to them as A, B, and C. If taxpayer A is a wage earner and all of his income is from salary he will be limited to a $25,000 deduction with respect to any borrowings which he may use in an attempt to create additional net worth for himself. I am assuming he has nothing, he is trying within our capitalist system to develop assets, and having nothing but his salary he goes to a bank or lending institution and using his ability to earn income, borrow funds, repays the loan, in the process creates capital assets.

If he had $50,000 worth of income and his borrowings created an interest deduction of $50,000, just to make the example simple, he would be entitled to only a $25,000 deduction under this provision.

Suppose taxpayer B doesn't work for a living but has investment assets which produce $50,000 of income. Under this provision he could borrow the same amount of money, pay $50,000 in interest but deduct the entire amount.

I submit I find the distinction between someone who has investment assets already and who is entitled under this provision to borrow in order to create additional assets, and the taxpayer and wage earner who has no assets and whose interest deduction is limited to be somewhat mystifying, but again in Mr. Surrey's argument before this committee or discussion with this committee, he dismisses this with a paragraph, without any logic to support his conclusion.

I suggest that the provision is another example of what can happen when a statute is hastily conceived, because of some general feeling that something is wrong with a section and a result is achieved which I don't believe anybody who would have thought the problem through from beginning to end would have thought was justifiable.

Taxpayer C compared to A and B could be engaged in his own business, borrow as much as he wants and invest it in that business because he is now engaged within a trade or business within the definition of this act and not be limited at all in the amount of interest he could deduct. I think it inappropriate to discriminate among taxpayers one of whom is a wage earner, another of whom earns all of his income from investments, and a third of whom is engaged in his own business, one not getting the advantage of deducting interest beyond the limitation—while two of them being entitled to deduct interest beyond the limitations afforded, the first being put in some special class to be treated differently because his sole source of income is from personal service.

I think it is unfortunate this kind of situation exists, and I would respectfully hope that the committee in its wisdom would provide for its elimination because I think it serves no ends other than to create additional discrimination in the Internal Revenue Code.

I know my time is limited and I would just like to bring to the attention of the committee two very serious technical defects in the provisions over and above the general falacy and policy which I hope I have already discussed to your satisfaction.

One is the provision which discriminates against partnerships and in favor of other types of landholding entites when it comes to real estate investment and with interest reductions with respect to such real estate. Individuals who own property as tenants-in-common would be given totally different treatment than the individuals who own real estate in partnership. From a business standpoint, and totally aside from tax considerations, there are significant reasons why individuals would want to own real estate in partnership when more than one individual is involved rather than tenants-in-common. They deal with economic convenience and convenience of administration and just sensible development of real estate. Yet again section 221, because of its lack of thoroughness in investigating a basic change in the Internal Revenue laws, would discriminate against partnerships and in favor of individuals who held property in some other fashion.

Finally, and one point which I think is probably as vital as anything else I have discussed today, is if the committee in its wisdom decides that this bill should be enacted in substantially its present form, I would call your attention to the effective date provisions because again the bill does something which to my knowledge is very, very seldom done with tax laws, in that it applies the law with a retroactive effect, and it does it in this fashion: It has an effective date provision which provides that it applies with respect to taxable years beginning after the current taxable year. However, it does not take into account the fact that individuals may have entered into contracts and/or may have achieved obligations, without regard to an understanding that the law was going to be changed. I submit that what should be done with this provision is the same thing that the Internal Revenue Service did when it enacted its ruling on prepaid interest which the Ways and Means Committee approved in the committee report, and that was that they do not apply the provision to contracts or obligations which existed prior to the date of the passage of the law.

In other words, what is important here is not when the interest is paid but whether the taxpayer in question was under an obligation to pay that interest because of a contract or obligation incurred before he could legitimately have had any knowledge of the application of these provisions.

I thank your committee very much for allowing me to be here, especially you, Mr. Chairman, and I suggest again I hope you give consideration to this provision which has not received a great deal of notice, public or otherwise, and which I feel is a provision which has much greater impact than it may appear to do.

The CHAIRMAN. Thank you very much.

Senator ANDERSON. Can I ask one question?

Mr. Surrey spent a great many years in tax study and he has been before this committee. Has he one word that you approve of?

Mr. FIMBERG. Oh, yes, sir; I think there are many things that I approve.

Senator ANDERSON. What are they?

Mr. FIMBERG. I approve of many of his statements throughout the tax bill. One statement with which I specifically take issue is the following statement, and I quote, "The Treasury argument that the provision discriminates against the person with earned income and no investment income, but borrowings invested in growth assets is hardly an adequate reason to drop the provision," I do disagree with that, sir.

I disagree that the tax laws should create any further discriminations than they already do. I think the object of tax reform is to try to create tax equality, not further discrimination. But I do not only approve of many of the things Mr. Surrey says, I am a great admirer of his. I just happen to disagree with that particular statement.

The CHAIRMAN. Thank you.

(Stanley R. Fimberg's prepared statement follows:)

STATEMENT OF STANLEY R. FIMBERG, BEVERLY HILLS, CALIF.

Section 221 of H.R. 13270 would amend Section 163 of the Internal Revenue Code of 1954 (relating to the deductions for interest) by placing a limitation on the amount of "investment interest" which certain specified taxpayers could deduct. "Investment interest" is a term which is specifically defined by the new provisions.

The undersigned respectfully submits that the proposed amendment to Section 163 is unsound both from a policy standpoint and in certain respects from a technical standpoint. Further, that the effect of this amendment will result in unfairly penalizing taxpayers who had made certain business decisions and closed transactions before they could have obtained any knowledge of the effect of this proposed new legislation.

A. ANALYSIS OF STATUTE

Section 221 would add a new subsection (d) to Section 163 of the Internal Revenue Code, which new subsection would be entitled "Limitation on Interest on Investment Indebtedness." This section would apply in the case of every taxpayer other than a corporation (except an electing small business corporation as defined in Section 1371(b)). Under this provision, the amount of "investment interest" which a taxpayer covered by the amendment would be entitled to deduct during a taxable year is limited to the sum of (i) Twenty-Five Thousand Dollars ($25,000.00), (ii) the amount of his "net investment income" and (iii) an amount equal to the amount by which his net long-term capital gain exceeds his net short-term capital loss for the taxable year. Additionally, a carry forward provision is allowed to the extent "investment interest" exists but the taxpayer in question cannot deduct the same in the taxable year in question. In essence, this amendment would limit a taxpayer's interest deduction to the sum of (i) Twenty-Five Thousand Dollars ($25,000.00), (ii) his investment income, and (iii) certain excess long-term capital gains.

The key terms which will be discussed herein are:

(1) Investment Income

"The term investment income means the gross amount of income from interest, dividends, rents, and royalties and net short-term capital gains derived from the disposition of property held for investment, but only to the extent that such gross income or such gains are not derived from the conduct of a trade or business." Proposed IRC § 164(d)(3)(A).

(2) Investment Expenses

"The term investment expenses means all deductions allowable under section 164(a) (1) or (2), 166, 167, 171, 212, or 611 directly connected with the production of investment income." Proposed IRC § 164(d)(3)(B).

(3) Net Investment Income

"The term net investment income means the excess, if any, of investment income over investment expenses." Proposed IRC § 164(d)(3)(C).

(4) Investment Interest

"The term investment interest means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." Proposed IRC § 164(d)(3)(D).

B. BASIC POLICY

(1) The basic policy of the new Section 163(d) is set forth in a Report of the Committee on Ways and Means of the House of Representatives which accompanied H.R. 13270. Such Report is H.R. No. 91-413 (Part I), 91st Congress, 1st Session. The Committee felt it was unfair to allow a taxpayer who borrowed funds to make an investment which did not create a taxable income to deduct that interest against his other income. They felt that the interest was a controllable expense and that a taxpayer should not, through deduction of interest, be allowed to insulate other types of income. The Committee stated:

"Your committee does not believe it is appropriate to allow an individual taxpayer to currently deduct interest expenses on funds borrowed for investment purposes where the interest expense is substantially in excess of the taxpayer's investment income."

The undersigned respectfully submits that the foregoing analysis is unsound. Merely because a taxpayer is primarily engaged in earning income from his personal services and hence is not in the trade or business of investing, if he desires to develop investment assets, the cost of developing such assets is an expense to him in the same way that someone involved in a trade or business incurs expenses to improve that business. Moreover, the basic policy of the statute would tend to be to discourage an individual who did not already have investment assets from acquiring such assets. Because of the high level of ordinary income tax on earnings from personal services the only way an individual who is basically a wage earner can accumulate any capital assets is through judicious borrowing for the purpose of creating such assets. The interest deduction afforded allows him to create a capital asset which he would otherwise not be able to do.

Unless the level of tax on salary income is substantially reduced, even below the top level as provided by the proposed legislation, it would seem that a policy of nondeductibility of interest coupled with a fifty percent (50%) or higher ceiling on salary income results in an unfair burden on the salaried taxpayer, and puts him at a significant disadvantage when compared to the taxpayer who is engaged in his own business. For example, it is not unusual for an individual who is attempting to build up the capital value of the business to expend sums which are deductible, e.g. salaries of employees, purchase of and *payment of interest* on loans used for expansion, inventory, etc., and thereby in effect reduce his taxable income while at the same time increasing the capital value of his business as an asset which he could sell. I submit that the expense of interest to an investor is not sufficiently different from those expenses to receive different treatment. It is just administratively easier. Further, to suggest that interest is a controllable expense is to say it is controllable in the event someone, substantially all of whose income is from services does not want to try to create capital assets greater than whatever small amount of income is left after paying his tax bill on his income from such services. Interest is equally controllable for an individual who borrows funds to expand his business. Surely to state that interest is controllable in one instance and not the other shows its fallacy. For it is only through borrowing that capital assets can be created for such a wage earner. Moreover, such borrowing will be impossible if the interest thereon is not deductible.

(2) A second and more basic problem with the policy of the statute is that it discriminates against individuals who do not have investment assets and who borrow funds in an attempt to create such investment assets, and in favor of individuals who have investment assets and borrow money to create additional investment assets. Under the proposal, an individual who has substantial investment income can borrow funds to create additional investment assets and not be subject to the same limitations as someone who has no investment income. That individual is subject to a flat Twenty-Five Thousand Dollars ($25,000.00) limitation. Such a basic discrimination is unwarranted and is another example of the basic fallacy underlying the provisions.

To illustrate, Taxpayer A has Seventy-Five Thousand Dollars ($75,000.00) of income, all of which is from wages. He borrows Five Hundred Thousand Dollars ($500,000.00) for the purpose of making an investment, and is charged interest of Fifty Thousand Dollars ($50,000.00) on such borrowing. He will be limited to a Twenty-Five Thousand Dollar ($25,000.00) deduction under the proposed amendment. However, Taxpayer B, all of whose income of Seventy-Five Thousands Dollars ($75,000.00) is from investments borrows the same Five Hundred Thousand Dollars ($500,000.00), and pays the same interest. He is not subject to any limitation on deductions of interest because he can offset his excess interest deductions against his "investment income." I think this simple example indicates the flaw in the reasoning behind the statute. Therefore, the attempted distinctions set forth to justify the different treatment given to the investor without other income and the investor with such income or given to the investor and one who is engaged in a trade or business really do not stand up under analysis.

C. DEFINITION OF INVESTMENT INTEREST

(1) Inconsistency between Section 163(d)(3)(D) and Section 163(d)(4)(C)

One of the technical problems with this statute arises because of an inconsistency between the definition of investment interest and a special definition governing rents. It should be remembered that under the policy of the statute, investment interest can be offset against investment income. Rents are considered to be one type of investment income so long as they are not derived from the "*conduct of a trade or business*". Proposed IRC § 163(d)(4)(C). A statutory definition is then set forth as to what is required for rental income to be considered to be derived from a trade or business. On the other hand, the definition of "investment interest" is interest paid or accrued on indebtedness incurred or continued to purchase or carry "*property held for investment*". The problem is whether or not the terms "property held for investment" and "conduct of a trade or business" are synonomous. The problem is illustrated by the following example:

A, an individual, is the owner of an apartment project. Because of the manner in which the business of the apartment project is conducted, the income derived therefrom is considered to be derived from the conduct of a trade or business in accordance with proposed Section 163(d)(4)(C) and hence is not investment income. Assume that gross rents derived from such apartment project are Three Hundred Thousand Dollars ($300,000.00) per year, and that such property is subject to a mortgage of One Million Five Hundred Thousand Dollars ($1,500,-000.00) on which interest in the amount of One Hundred Twenty Thousand Dollars ($120,000.00) per annum is paid. Assume further, that after taking all deductions attributable to the operation and ownership of the property, that A has taxable income of One Hundred Twenty Thousand Dollars ($120,000.00) per annum, and that said taxable income is his only taxable income. The issue is whether or not the One Hundred Twenty Thousand Dollars ($120,000.00) of interest income is deductible by A without limitation or whether or not it constitutes investment interest. From a policy standpoint, the interest should be deductible since the income derived from the property and reportable by A is not investment income, within the definition of proposed Section 146(d)(4)(C).

However, because of the manner in which the statute is drafted, although the rent from the property is not investment income, the interest paid on the mortgage encumbering the property may be investment interest. This would mean that A would not be able to offset such interest against his income from the property and would end up paying tax on such income without the availability of the deduction which is attributable to payments made with respect to the property. Obviously, such a result was not intended and should be corrected. Such deficiency could be corrected by amending the definition of investment interest by providing a sentence at the end: "Any property, the income from which is considered to be derived from the conduct of a trade or business, pursuant to Section 163(d)(4)(C) will not be considered to be property held for investment".

(2) Problem of Construction Interest

Another problem which the statute creates is whether or not interest paid on real property which has been improved by the taxpayer is deductible. Certainly, if interest should be deductible with respect to any type of investment, it should be deductible with respect to an investment where the taxpayer in question constructs improvements on Property. Although there is no question with respect to the deductibility of interest on the construction loan, once the project is completed, interest paid on the underlying indebtedness could be said to be "interest paid on an indebtedness *continued* to *carry* property held for investment." The reason for this is that once the project is completed then the purpose of the loan could be said to be to "carry property held for investment." Certainly any taxpayer who has been involved in the risks of construction will not take such risks if they are penalized once construction is completed. Therefore, proposed Section 134(d) should be amended to provide that a taxpayer who is responsible for the construction and improvement of property is entitled to deduct the interest paid in connection with any indebtedness thereon during the useful life of the Property.

C. PARTNERSHIP LIMITATION

Another provision which is grossly unfair is the proposed Section 163(d) (4(A) which provides as follows:

"In the case of a partnership, the provisions of this subsection shall apply with respect to the partnership and with respect to each partner."

The impact of this provision is to provide that a partnership may not deduct more than Twenty-Five Thousand Dollars ($25,000.00) of investment income, without regard to the number of individuals who are in the partnership. Again, this provision when applied to the ownership and operation of real property is both discriminatory and unnecessary. It is discriminatory in that it discriminates in favor of a particular method of the ownership of property as opposed to another. A group of individuals can get together as tenants in common and own a piece of real property and each individual will be entitled to have the limitation applied to himself individually with no limitation to the tenancy in common. The same would be true as to joint tenants. However, in connection with the ownership and operation of real estate, there are often reasons why it is more advantageous from an overall standpoint to own property in partnerships as opposed to owning it as tenants in common. However, this statute will force people who ordinarly would create partnerships to create tenancies in common, which do have certain business disadvantages. Since the limitation can easily be applied to each partner on a separate basis, there appears to be no reason why the limitation at the partnership level is required. Moreover, there is no reason why a tax provision should cause people to be forced to restructure their legal relationships in some manner which would have most of the benefits of a partnership without being considered a partnership for tax purposes.

D. EFFECTIVE DATE PROVISIONS

New section 163(d) of the Internal Revenue Code is to be applicable to taxable years beginning after December 31, 1969. It is respectfully submitted that the foregoing application is unfair and inconsistent with the normal method of handling changes of this kind. Indeed, the Internal Revenue Service when it enacted its prepaid interest ruling on November 26, 1968, which ruling is referred to with favor in the Committee Report to H.R. 13270, provided that such ruling would not apply to interest payments made pursuant to a contractual obligation entered into prior to November 26, 1968. Similarly the limitations on deductibility of interest provided in new Section 163(d) should not apply with respect to any indebtedness which was either outstanding prior to the date when the bill becomes a law, or with respect to which a binding contract existed prior to such date. In other words, many taxpayers are presently paying interest on obligations which were incurred prior to the time when they could be said to have had any indication that the proposed rules for deductibility of interest were to be changed. Therefore, at a minimum, fundamental fairness would require that the limitation of proposed Section 163(d) should not apply to interest paid in connection with any indebtedness or obligation incurred or contracted to be incurred before the date the statute becomes law.

E. SUMMARY

To summarize, it is respectfully submittted that:

(1) Because of the basic discrimination of proposed Section 163 that the section be deleted in its entirety. For the reasons heretofore indicated, it creates inequities that are antithetical to real tax reform.

(2) If for some reason the committee in its best judgment decides not to delete proposed Section 163(d), at a minimum the changes set forth herein

with respect to: (a) the application of proposed Section 163 to partnerships, (b) the technical deficiencies, and (c) the effective date of legislation should be made in Section 163(d).

The CHAIRMAN. Mr. Frederic Hickman of Northwest Industries, Inc.

STATEMENT OF FREDERIC W. HICKMAN, NORTHWEST INDUSTRIES, INC.

Mr. HICKMAN. My name is Frederic W. Hickman. I represent today Northwest Industries, Inc.

My statement concerns section 411 of the bill which begins on page 219. That section disallows interest on certain corporate indebtedness. The indebtedness involved is indebtedness which has three features. First, it is issued in an acquisition or to provide consideration for an acquisition.

Second, it is convertible into stock or is issued as part of an investment package which includes an option for stock.

Third, it is subordinated to other creditors.

If the indebtedness meets all of these tests then the interest on it is disallowed unless the ratio of debt to equity of the issuing corporation is no greater than 2 to 1, and the projected earnings of the issuing corporation are at least three times the interest expense.

There is an exemption in the bill for interest up to $5 million, but the $5 million is reduced by the amount of interest issued on any other debt issued in connection with past acquisitions.

This provision is an outgrowth of H.R. 7489 which was introduced in the House last February. The original House bill had no ostensible tax reform purpose in the sense that it was closing loopholes or otherwise. It was intended, frankly, to penalize corporate takeover bids which were then much in the news. Several established managements were at that time threatened by takeover bids, that is, there were offers out for their stock to their stockholders.

The original bill would have protected entrenched managements against that kind of threat at the expense of their individual stockholders and at the expense of the free market system.

The transparent purpose of H.R. 7489 is clearly illustrated by the fact that as originally introduced it would have applied only to acquisitions of stock as distinguished from acquisitions of assets.

This is significant because a tender offer for stock goes directly to the stockholders, bypassing the management of the company to be acquired. Thus, stock acquisitions were to be penalized.

Asset acquisitions, on the other hand, cannot be effected without the cooperation and sympathetic collaboration of the management and, as a result were not to be covered by the original bill.

The House bill was generally referred to in the press and otherwise as the anticonglomerate bill. Section 411 is referred to on your hearing calendar as the conglomerate question. The bill, however, would affect other than conglomerates and reach a number of other situations.

The House bill originally introduced was taken up in the House in connection with the general tax reform bill. It underwent a substantial metamorphosis and has now emerged in considerably different form as section 411 of H.R. 13270.

The principal change from the original bill, H.R. 7489, has been to give the proposal a respectable tax reform purpose. The House committee report now states that the purpose of the section is to distinguished debt which is real debt from debt which has so many characteristics of equity that it should be treated as equity by not allowing the deduction for the interest; that is, by treating such interest as essentially equivalent to a dividend.

With that background, I suggest to you that there are three primary defects in section 411 as it is presently drafted. First, it still contains features which have no relevance to the stated purpose of distinguishing between real debt and debt which is more clearly like equity. There are still what may be called hangover aspects from the original bill which seem, frankly, designed simply to penalize corporate acquisitions and takeovers.

The second defect is that the rules which section 411 does prescribe for distinguishing true debt from what we might call equity debt are not good rules. A debt-equity test such as the bill provides is generally regarded in the financial community today as obsolete, and, in any event, both the debt-equity test and the earnings coverage test operate with numbers and in a manner which is totally unrelated to anything in the financial community.

The third principal defect in section 411 of the bill as it now stands is the effective date. The effective date is May 27, 1969. That is the date on which the Committee on Ways and Means issued a press release describing in vague terms the provisions of the present section. The present section, which did not appear until August 2, is quite different in several major respects from what was suggested in very sketchy form in the press release. Thus the adoption of section 411 of the bill would retroactively incorporate features of which no one could have been aware on May 27.

Let me illustrate just briefly one of the provisions of section 411 which is a hangover from the prior bill in the sense that it penalizes corporate acquisitions. Section 411 still applies in a way which favors asset acquisitions as distinguished from stock acquisitions. Debt which is issued for assets is tainted only if more than two-thirds of the assets are acquired. But debt which is issued for stock is tainted if only a single share of stock is acquired. In actual fact, whether or not debt is "true debt" or "equity debt" has nothing whatever to do with whether it was issued in connection with an acquisition; but it surely has nothing to do with whether it was issued in an acquisition for stock or for assets.

At the very least, section 411 should apply equally to stock and to asset situations and should be confined, as the asset situation now is, to acquisitions of at least a majority—at least 50 percent of either the assets or the stock. In that way normal acquisitions of stock for investment purposes, for assured sources of supply, or what have you would be left undisturbed.

A second hangover feature appears in connection with the $5 million exemption.

The original press release indicated that that exemption was to be a flat exemption of $5 million.

It is now, under the current version of the section, reduced by interest on any prior debt used for acquisition purposes. So corporations are now to be penalized for past acquisitions, acquisitions which were in all respects proper at the time they were made.

The company which I represent today is a company which is an outgrowth of the diversification program of the Chicago and Northwestern Railway Co., so that we are particularly aware of railroad factors.

The railroad industry provides a good illustration of the absurdity of the formula for reducing the $5 million exemption. I call your attention to the fact that many existing railroads are the product of acquisitions in the 19th and early part of the 20th century of other smaller roads, a great many of which were acquired by the issuance of debt. Much of the financial debt structure on railroads at the present time is traceable to the refunding of those original obligations. So that, for a railroad, under the very broad language of the bill the $5 million exemption would be reduced by existing funded indebtedness which is attributable to acquisitions which were made back before the turn of the century and which surely have nothing to do with any legitimate tax reform purpose today.

Another factor in the railroad industry that illustrates the eccentricities of the provision for reducing the $5 million exemption arises out of the fact that a number of railroads went through bankruptcy in the 1930's and 1940's. The customary technique in a bankruptcy reorganization is for the assets of the debtor road to be conveyed to the new reorganized road in return for the securities of the new road. Under the very broad language of the bill those securities issued in bankruptcy reorganization situations would technically be debt issued in connection with acquisitions of assets, and would again reduce the $5 million exemption.

So far as the tests in the bill at the moment are concerned, that is the debt equity and the earnings coverage tests, these I have covered in considerable detail in the written statement which I have submitted. I would like to make just a few general points.

Looking first to the debt-equity test, it is generally dismissed today as not constituting a meaningful test. It is just not used, surely not used in the form in which it appears in the bill.

The earnings coverage test is perhaps somewhat more realistic but it has several unsatisfactory aspects which should be noted. It purports, first, to be based on projected earnings, but that is a misnomer because it is really a historical earnings test. It is a measure of the earnings in the last 3 years. In the case of a stock acquisition it doesn't even include the earnings of the acquired corporation unless 80 percent of the stock is acquired. This is another instance of the hangover, penal aspects discriminating against stock acquisitions as dis-

Second, we are not really dealing with earnings at all. We are dealing with earnings and profits, which is a fact which the original press release did not advert to. Earnings and profits may have some resemblance to earnings but it is, as all of you know, a very artificial tax concept and quite different from financial earnings. For example, the use of accelerated depreciation may not reduce financial earnings but it does reduce earnings and profits, so that companies which have been using accelerated depreciation would be discriminated against in the sense that the earnings on their financial statements which would be used by the financial community would normally be substantially greater and, therefore, meet the test more readily than would earnings and profits.

The third thing about the earnings coverage test is that it is unrealistic in the sense that companies do not pay interest out of earnings. They pay interest out of cash and, consequently, it is generally agreed in the financial community that cash flow is a much better test than an earnings test.

So even if you were to adopt something in the nature of an earnings test it should be modified at least by adding back such noncash charges as depreciation and amortization.

Last, there is no support for the 3-to-1 ratio which the bill uses that we can find either in the financial community or in the academic community. The railroad industry data which is reproduced at pages 10 and 11 of the written statement indicate that in only 1 year during the 10-year period ending in 1967 did the railroad industry, taken as a whole, meet its fixed-interest charges out of earnings by as much as three times. Given that kind of data we suggest to you that an earnings coverage test, if one is to be used at all, should be one and a half or, at most, two times the interest charges in order to conform to realty.

We suggest to you that in prescribing these tests, section 411 of the bill has elevated rules of thumb into rigid rules. If we are going to have to live with rules of thumb—we would hope that we were not, but if we are—then we urge that they be good rules of thumb that more closely conformed to what is economic realty.

In conclusion, I would like to submit that section 411 of the bill devises very complex and unrealistic rules to deal with what is at best a minor problem and probably not a tax problem at all. As a solution it will present greater problems than the problem at which it is addressed.

It should be, we submit, deleted from the package of legislation. It is not deleted in its entirety, then we suggest to you that there should be deleted at least those provisions which have nothing to do with separating real debt from debt equity, and that if we must live with rules of thumb they should be at least adjusted to make them as realistic as possible.

Thank you.

The CHAIRMAN. I just want to ask one question. Wasn't this bill really tailored as a tax measure to strike at an antitrust problem and it would appear to be an effort to prevent the acquisition and control of B. F. Goodrich by Northwest Industries?

Mr. HICKMAN. I would hope that the bill was not intended to be that specific but that transaction was surely in the climate at the time. It does seem to us that, to the extent that there is a problem, it is an economic problem, an antitrust problem, and not properly a tax problem at all.

The CHAIRMAN. Well now, hasn't the Antitrust Division of Justice been very active in this area since this problem of conglomerate mergers came up?

Mr. HICKMAN. They have been very active. And since the time the bill has been introduced the stock market itself, which is perhaps the best regulator of any of these activities, has made most of them undesirable and unattractive, and the commotion has largely dissipated at this point in time.

The CHAIRMAN. What is the present status of the proposed merger?

Mr. HICKMAN. The exchange offer by Northwest Industries for stock of B. F. Goodrich terminated last summer. Under the exchange offer Northwest acquired stock of Goodrich which, when added to the substantial block of shares owned by Northwest prior to the offer, brought its ownership to approximately 16.4 percent of the outstanding common stock of Goodrich.

The CHAIRMAN. Thank you.

Senator MILLER. Isn't the main thrust of your criticism that whether we have a transaction involving a merger or some other type of a business transaction that the basic question is whether we have a debt or an equity instrument and, of course, we have had a lot of trouble and a lot of litigation in some cases on drawing a line between whether in a particular case you have a debt or whether in a particular case you have an equity and if you have an interest you don't get an interest deduction. The tax libraries are full of cases like that and, I take it, your point is that if there is going to be any change that we should do it across the board. So that whether you are involved in what the Antitrust Division might have an interest in or whether you are involved in some little insignificant matter in some little town the question still is whether we have a debt or an equity instrument, and if there needs to be some refinement of that, of the definition so that the administrative problem of dealing with that will be eased, that is what we ought to do instead of singling out some particular area such as the House bill has done. Is that the main thrust of your statement?

Mr. HICKMAN. That is exactly the main thrust of my position.

I would like to just add a comment. You referred to the fact that the books are full of cases trying to distinguish debt from equity. Practically all, if not all, of those cases involve nonarm's length transactions which can be cast in the form of debt as well as they can be in the form of equity and there are no market or arm's length factors operating to distinguish automatically. I suggest to you that in this situation all of these transactions are arm's length transactions in which the public accepts these instruments as debt. Under those circumstances it seems to me that to even try to draw this kind of distinction is unwarranted when we have a better public measure than anything the bill could devise.

The CHAIRMAN. Well, of course, if you have an arm's length transaction simply calling something a debt rather than an equity isn't going to satisfy. I don't think the mere fact that you have an arm's length's transaction is necessarily conclusive on the point. That is part of the problem, and to draw the guidelines is difficult. But if guidelines are drawn in arm's length type transactions it would seem to me that they ought to be across-the-board regardless of whether it is something that is in the area of the antitrust interests or something else.

Mr. HICKMAN. I agree.

The CHAIRMAN. Thank you very much, sir.

(Mr. Hickman's prepared statement follows:)

STATEMENT OF FREDERIC W. HICKMAN, CHICAGO, ILL., REPRESENTING NORTHWEST INDUSTRIES, INC., CHICAGO, ILL.

SUMMARY

1. In general

The House Report indicates that the purpose of section 411 is to disallow interest deductions on certain obligations where the obligations, though designated as debt, are more realistically considered as equity. The Report states:

"Your committee does not believe that many corporate bonds and debentures which presently are being treated as debt are, in fact, debt rather than equity. . . . The characteristics of these bonds or debentures, such as convertibility and subordination, in many cases make them more closely akin to stock than to debt. . . . Your committee is particularly concerned with the present situation, which involves an increasing amount of debt used for corporate acquisition purposes, in view of the fact that it normally is much easier to effect a substitution of debt for equity at the time of a corporate acquisition." (p. 104)

In several significant respects, section 411 is not consistent with that stated purpose.

The target at which section 411 is directed is not primarily a tax reform target, and to the extent there is a tax reform target the aim is faulty. The additional inequities and complexities raised by section 411 are not justified by the alleged problem at which it is directed and the section should be deleted.

2. Inconsistent application to stock and asset acquisitions

A. The provision applies to any acquisition of stock but only to the acquisition of ⅔ of the assets of a corporation. No support for this inconsistency can be found in the stated rationale of the section.

B. The provision should not apply to any acquisitions of less than a 50% interest. That would permit noncontrol acquisitions for such ordinary business purposes as investment and assuring sources of supply.

3. Earnings coverage test

A. Earnings coverage tests have been rejected by the financial community as unrealistic. The better test is a cash flow test. Accordingly, the provision should require depreciation and amortization charges to be added back to earnings.

B. The inflexible 3-to-1 earnings coverage requirement is unrealistic. For example, only once in the ten year period 1958–1967 did Class 1 Railroads as a whole have earnings which covered their fixed charges 3 times.

C. The historical earnings of an acquired company should be included in projected earnings even if less than 80% of a company is acquired. The test purports to estimate future earnings and should thus include those which the acquired company will contribute.

D. There should be a second chance to pass the earnings test (and the debt equity test). A deduction should not be lost forever merely because a company has had one bad year.

4. The $5,000,000 exemption

A. The $5,000,000 exemption should not be reduced for interest on debt incurred in connection with prior acquisitions. To do so would penalize companies for events of the past which were consistent with law and sound business policy.

B. To reduce the $5,000,000 exemption for interest on debt incurred in any acquisition—even though it was not the prohibited type of debt—is contrary to the stated philosophy of the provision.

5. Tracing problems

A. The provision encompasses interest on debt issued "to provide consideration for" the acquisition of stock or assets, creating tracing problems whenever a corporation issues the prohibited sort of debt and thereafter, at any time, makes an acquisition.

B. Because the $5,000,000 exemption is reduced for interest on debt incurred in connection with prior acquisitions a corporation is forced to review its entire history to determine if there is debt outstanding which arose in that manner.

6. The effective date provision

A. The May 27, 1969 date is the date of a preliminary press release which was careful to describe its brief description of this provision as tentative. In its present form, § 411 differs substantially from what was proposed in the May 27 press release. Legislation of this drastic sort should not become effective until its scope has been made clear.

B. Many corporations were in the process of acquiring interests in other corporations on May 27. Some leeway should be made for acquisitions in process during the relevant period. The date of enactment is suggested as the effective date.

7. Conclusion

A. § 411 should be deleted. It is not addressed to a genuine tax problem and would create more problems than it solves.

B. If it is not deleted, then it should be modified:

(1) to make the section effective not earlier than the date of enactment.

(2) to delete those aspects which are designed simply to penalize corporate tender offers, namely the provision would penalize acquisition of even a single share of stock and the provision reducing the $5,000,000 exemption.

(3) to make the tests for distinguishing "true debt" from "equity debt" more realistic, by

a. deleting the debt-equity ratio test;

b. modifying the earnings coverage test by making it 1½ to 1, or at most 2 to 1, and by making it conform more closely to cash flow by adding to earnings profits the amount of depreciation and amortization.

STATEMENT

Section 411 of the Tax Reform Act would deny an interest deduction with respect to certain indebtedness incurred after May 27, 1969.

The Committee Report states (and in general the scheme of the section corroborates the statement) that the intent is to deny an interest deduction in situations where the features of the debt and the risk involved are so similar to equity that the debt should be treated for tax purposes as equity. See H. Rep. 91–413 (Part I), Report of the Committee on Ways and Means to accompany H.R. 13270, at page 104 where it is stated:

"Your committee does not believe that many corporate bonds and debentures which presently are being treated as debt are, in fact, debt rather than equity. . . . The characteristics of these bonds or debentures, such as convertibility and subordination, in many cases make them more closely akin to stock than to debt. . . . Your committee is particularly concerned with the present situation, which involves an increasing amount of debt used for corporate acquisition purposes, in view of the fact that it normally is much easier to effect a substitution of debt for equity at the time of a corporate acquisition."

To the extent that this is the purpose of the Bill—i.e., to treat as equity that which is not realistically debt—it is a legitimate revenue concern.

However, certain portions of Section 411 have no relevance to distinguishing debt from equity and are obviously carryovers from an earlier version of the proposal which was intended simply to penalize corporate acquisitions of a "conglomerate" nature. For example, subsection (a) of Section 279, which would be added to the Internal Revenue Code by Section 411, would penalize the past issuance of debt for acquisition—whether or not it has any characteristics of equity—by causing it to reduce the $5,000,000 exemption which the proposal would otherwise allow. To so penalize debt simply because it was issued in connection with past acquisitions may be a proper *legislative* purpose (assuming it is determined such acquisitions are undesirable), but it is hardly a proper *revenue* or *tax reform* purpose.

Whatever may be the ultimate economic and social implications of the diversified expansion by corporate managements through acquisitions financed in part by debt, it is urged that the Committee eliminate from Section 411 those features which have no bearing on determining what is realistically debt and what is realistic equity, or which provide unrealistic rules for that determination.

Finally, it is earnestly suggested that the remedy proposed by Section 411 presents tax problems far greater than those at which the section is directed and that the section should be deleted from the bill.

The degree of ownership required

The current provision defines "corporate acquisition indebtedness" as debt utilized in the acquisition of *any* stock of another corporation or at least *two-thirds* of the assets of another corporation. As there is no distinction between the two types of acquisitions with respect to the type of debt which may be issued, the only possible distinction between stock and asset acquisitions is that generally asset acquisitions are made with the cooperation of the management of the acquired corporation whereas stock acquisitions may or may not be made with management approval. Thus for reasons not disclosed in the House Report, the bill would seem aimed at discouraging tender offers for stock. This goal, whether or not desirable, is not the proper focus of a revenue measure and, of course, has nothing at all to do with the ostensible "debt-equivalent-to-equity" rationale of the bill.

It is submitted that the percentage of ownership, whether acquisition be made of stock or assets, should be limited to acquisitions of control, and that the test should be a consistent one—perhaps 80%, perhaps 66⅔%, and probably in no event less than 50%. In this manner acquisitions for investment purposes, for purposes of assuring sources of supply or for other common business reasons will not be hampered. Moreover, the choice of the form of "friendly" acquisitions of less than two-thirds of a company need not be altered from stock acquisitions to asset acquisitions to comply with the noneconomic requirements of the tax laws.

The debt-equity and earnings coverage tests

In determining whether an obligation which is in form debt is more realistically treated as equity the fundamental inquiry must be whether the degree of risk involved more closely resembles the risk customarily associated with equity investments or whether it is the lesser risk customarily associated with debt. This is a complex, factual question in most circumstances. The bill adopts a double test which is similar to rough rules of thumb often used in the financial community. The bill, however, elevates these rough rules of thumb to ironclad requirements and in some respects does so most unrealistically. If it is possible to provide only a rough rule of thumb in such a statute, taxpayers who must live under it should be provided a standard as realistic as possible and sufficiently generous so that it will only rarely penalize situations which would be clearly proper under a more accurate and sophisticated test.

The definitive analysis of realistic debt levels is a book entitled "Corporate Debt Capacity," written by Professor Gordon Donaldson of the Harvard Business School, and published by Harvard in 1961. With respect to the debt-equity test, i.e., the "balance sheet" standard, Professor Donaldson states:

"The conclusion of this study is that balance sheet ratios are in this respect unnecessarily crude and unreliable and as a result can be a dangerous way of expressing a risk-bearing standard, at least so far as industrial borrowers are concerned." (at p. 150)

The reasons, briefly, are:

(1) simple ratios do not reflect the timing of cash flows—"given any principal amount of debt the hazard to cash solvency could vary significantly depending on the term and the decision on balloon payments";

(2) balance sheet values do not reflect fair market values;

(3) asset composition may change;

(4) off the balance sheet items bear directly on the question of cash solvency.

With respect to the earnings-coverage test, i.e., the "income statement" standard, the book states:

"The use of an earnings coverage standard for debt capacity, by shifting attention away from assets to what they actually earn and away from the principal amount of debt to the related fixed annual cash outflow, moves a long way in the direction of relating the standard to the factors directly involved in cash solvency. Obviously several of the potential misconceptions inherent in the balance sheet standard are avoided.

"In spite of its advantages, however, two major problems detract from the usefulness of the earnings coverage standard. One relates to the question as to whether Net Earnings is an adequate representation of the *cash* available for debt servicing, since in thhe last analysis solvency can only be preserved if the ability to make cash payments on time is assured. The other relates to the question of the precise meaning of the 'coverage' . . ." (at p. 152)

The study concludes that neither the debt-equity nor earnings coverage tests is acceptable; but that corporate debt capacity should be determined in the light of *cash flows:*

". . . The conclusion [is] that the most use*ful approach to an appraisal of risk and a meaningful debt standard lies in such an analysis—but not in terms of accounting values, rather in terms of cash flows.*" (at pp. 154–55)

All of the reasons pointed out by Professor Donaldson as to why the debt-equity test is of limited validity are present here. In addition, while the traditional debt-equity test is deficient in using accounting balance sheet numbers rather than fair market values, the proposed statutory test would substitute an even more artificial balance sheet based on the adjusted basis tax figures. The result is a complete departure from reality.

Moreover, the normal application of the debt-equity test relates only to what is generally referred to as long-term debt, i.e., indebtedness the maturity of which occurs more than one year from the date of the balance sheet. Such a test is irrational as applied to current debt—as Section 411 would provide—because the ratio of debt to equity will vary greatly depending on the sheer accident of whether the corporation has or has not paid off its current debt, a relatively easy matter.

The earnings coverage test, as Donaldson points out, is more realistic than the debt-equity test and a cash-flow test is better than either of them—although all three have serious deficiencies if one attempts to apply them in a rigid formula manner.

If rough rules of thumb such as these are to become statutory requirements, then at least the best rules of thumb should be used. Accordingly, it is urged that the debt-equity test be deleted and that the earnings coverage test be revised to use cash flow rather than earnings as the test of capacity for servicing the corporate indebtedness. While accountants differ in their approach to determining cash flow, the largest single items affecting the difference between earnings and profits and cash flow are customarily depreciation and amortization. Thus, in order to come as close as possible to a cash-flow approximation without getting mired in accounting refinements, it is proposed that the figure used be the sum of the earnings and profits for the year, plus the depreciation and amortization deductions taken in arriving at earnings and profits. This would also eliminate the effect of any accelerated depreciation (which is generally not reflected in earnings in financial statements under accepted accounting principles) and would, accordingly, eliminate the unjustified discrimination in this respect against companies using accelerated depreciation for tax purposes.

The 3-to-1 Earnings Coverage Ratio. The House Committee Report does not reveal from what source the 3-to-1 earnings ratio test was derived and we find no academic or financial authority for it. Our own experience suggests that it is too stringent.

The corporate group which I represent at this hearing is Northwest Industries, Inc. and its subsidaries. That group of companies is the result of a diversification program originally undertaken by the Chicago and North Western Railway Company.

The necessity to diversify is especially great in cyclical industries, such as the railroad industry, for effective long range capital planning is possible only with reasonably stable earnings. Thus, as you perhaps aware, a number of railroads have been recently engaged in diversification activities. Under these circumstances it is significant to note that taking Class I railroads as a group they have only earned their "fixed charges," (defined by Moody's Transportation Manual as interest, accumulating discount on debt and certain roadbed lease charges) three times once in the ten year period 1958–1967. The following table is taken from Moody's Transportation Manuals and shows the times fixed charges were earned for Class I railroads for the longer period 1926–1967. Calculations are based on data as reported to the ICC on a flow-through basis with no recognition of deferred income taxes.

Year(s)	(Times fixed charges earned)
1926–1935	1.51
1936–1945	1.63
1946–1955	2.47
1956	3.12
1957	3.14
1958	2.73
1959	2.68
1960	2.33
1961	2.16
1962	2.67
1963	2.89
1964	2.94
1965	3.14
1966	2.95
1967	2.28

The foregoing data clearly suggests that the 3-to-1 earnings ratio as applied to the railroad industry is a very stringent test, operating to inhibit diversification in an industry which sorely needs it. And because of the cyclical nature of the railroad business, the test would operate much more stringently some years than others.

We submit that if an earnings coverage test is to be used, it should be 1½-to-1, and in no event greater than 2-to-1.

Earnings of the Acquired Company. The earnings coverage test provided by the bill uses the terminology "Projected Earnings," which is a misnomer inasmuch as it is historical earnings which are utilized. The past earnings of the *acquired* corporation, however, are not taken into account unless the issuing corporation has acquired 80% of the stock or substantially all of the assets. This is most unrealistic. The stock or assets acquired in fact do contribute to the earnings which will be available to service the debt, either by means of dividends or other distributions in the event of a stock acquisition, or by means of cost savings or increased revenues in the event of an asset acquisition. Accordingly, it is urged that the test be revised to take into account at least the expected dividend yield in the case of a stock acquisition and a pro rata share of the earnings (preferably earnings plus depreciation and amortization as explained above) of the acquired corporation in an asset acquisition—and preferably, for consistency, the pro rata share of earnings in both instances.

The present provisions of the bill permit the inclusion of earnings of the acquired company only when there is 80% control in the case of a stock acquisition or when substantially all of the assets have been acquired. We submit that there is no reason why such a provision should apply, permitting all of the earnings to be taken into account when a magic point has been achieved and none of the earnings to be taken into account when it has not.

Subsequent Qualification Under the Earnings Coverage Test. As the proposal stands, if a company's *historical* earnings would not cover interest on debt *to be* issued, the interest deduction is disallowed. We submit that the corporation should not be judged solely on the basis of earnings of the recent past, but should be given a chance to prove that it can cover its interest.

The timing of a proposed issuance of equity may be such that a bad earnings history—often the very reason for an acquisition—would result in a disqualification under the 3-to-1 earnings coverage requirement. In circumstances such as these, the corporation should have an opportunity to demonstrate that its debt was truly debt—even under the standards of the provision—by reference to events subsequent to the acquisition. Accordingly it is suggested that the provision be modified to allow a deduction—perhaps retroactively—if the tests are met in, say, two of the three years subsequent to the acquisition or on the basis of the average figures for that three year period.

The $5,000,000 exemption

As referred to above, under proposed subsection (a) of proposed § 279 interest would be disallowed only to the extent that it exceeds the excess of $5,000,000 over the amount of interest on indebtedness issued to provide consideration for the acquisition of stock or assets. As the provision is written, any interest payable on indebtedness incurred to acquire assets or stock, *regardless of when and under* *what circumtances issued*, would reduce the $5,000,000 exemption. Thus this portion of the proposal would apply to interest on any debt—new or old, convertible or nonconvertible—and has no relevance to the question whether such debt is economically the equivalent of equity.

An example of the extreme result of the provision as presently drafted can be found in the railroad industry. Most major railroads today are the result of acquisitions of numerous smaller railroads in the 19th and early part of the 20th century. Much of the present indebtedness of such railroads is likely to be represented by obligations which are refinancings of bonds originally issued for the acquisition of those smaller roads. The broad language of the bill would appear to cause such indebtedness to reduce the $5,000,000 exemption. To enact a new Code section which would cause present exemptions to turn on what happened a century ago is surely absurd. It is totally unrelated to any present-day concern with mergers and acquisitions.

The railroad industry provides still another example of the eccentricity of the provision reducing the $5,000,000 exemption. Many existing railroads are the product of bankruptcy reorganizations in the 1930's and 1940's, in which bonds of the presently existing corporations were issued in exchange for the assets of the debtor corporations. These bonds, too, would appear to be swept up in the broad language of the bill as reductions of the $5,000,000 exemption. Again, the have no conceivable relation to current merger and acquisition considerations.

Further, if it becomes necessary to consider not only the indebtedness on which interest is disallowed but also to analyze all prior indebtedness, whenever issued, in order to determine whether it affects the $5,000,000 exemption, that fact will create acute tracing problems, as each borrowing transaction in the history of the enterprise will have to be analyzed and an attempt made to trace funds during periods long gone.

Finally—and most fundamentally—to reduce the $5,000,000 exemption for those companies which have a history of acquisitions is to penalize companies today for events of the past which were consistent with then applicable law and, indeed, with sound business policy.

Accordingly we submit that the $5,000,000 exemption should be a flat exemption for interest on any corporate acquisition indebtedness. The existing provision reducing the exemption should be deleted as having nothing to do with the termination of whether currently issued obligations are realistically debt or equity and as irrationally penalizing the use of debt in past years.

At the very least, if the $5,000,000 exemption is to be reduced by interest on other than corporate acquisition indebtedness, it should apply only to other indebtedness issued after the effective date of the provision. As so applied it might have some deterrent effect on corporate acquisitions in the future and would not operate simply as a penalty on past acquisitions. (We suggest, however, that if the tax-writing committees are clear that such a blanket deterrent on future corporate acquisitions is desirable they may also wish to consider revision of the tax-free reorganization sections of the Code, which provide the major tax incentive to most acquisitions and mergers.)

The tracing problem

The cornerstone of Section 411 is the definition of "corporate acquisition indebtedness" found in subsection (b) of proposed new Code § 279. That definition includes not only debt issued directly as consideraton for the acquisition of the stock or assets of another corporation but also debt issued for money which is in fact subsequently used for such an acquisition. However, in many, if not most, situations it is impossible to trace whether specific funds have been used to acquire corporate stock or assets. If a company takes in $100,000 from its operations in one year and borrows $10,000 during the same year, how does one know whether it was the dollars from operations or the dollars from the loan that were used to make an acquistion? It does not suffice to rely on simple formalities such as segregated accounts, etc., because they are too easily adjusted one way or the other. Nor is it any help to ignore the formalities and rely upon the "realties" because the reality is that dollars are fungible and it is not possible to say in many cases which dollars went where.

The courts have been struggling for some years with a similar problem under Section 265 of the Code, relating to indebtedness incurred to carry tax-exempt obligations. No satisfactory rule—and not even a clear rule—has yet evolved. It is a bad law which creates unclear standards and it is an abdication of legislative responsibility simply to pass the buck to the courts when it is obvious in advance that the standards set are not susceptible of clear judicial resolution.

We submit that the problem could be largely eliminated without distorting the purpose of Section 411 by confining the term "corporate acquisition indebtedness" to debt issued *directly* as consideration for acquisitions and by deleting the terminology "provide consideration for" in subsection (b)(1) of § 279, which extends the definition to debt issued for cash. Section 411 is directed at what was repeatedly referred to in the House hearings as "funny money," and the House Report emphasizes that the context of an acquisition provides a peculiar opportunity to gain acceptance of such obligations. But if the debt can in fact be issued for cash, then you do not have the kind of "funny money" which proponents of the legislation were decrying nor the peculiar opportunity referred to in the House Report.

Thus, we submit that obligations issued for cash meet the normal arm's length standards of the marketplace—regardless of what the cash may ultimately be used for—and should be deleted from the definition of corporate acquisition indebtedness. There should also be deleted from subsection (h)(1) the reference to "refinancing" of an obligation, since a refinancing involves the issuance of debt for cash and thus also provides assurance that the debt does not constitute "funny money."

The effective date provision

Section 411, as adopted by the House, applies to indebtedness incurred subsequent to May 27, 1969. That date is the date of a preliminary press release issued by Chairman Mills of the Ways and Means Committee outlining in the most general terms various proposed sections. As the Release was very careful to describe its decisions as tentative and as the description of § 411 was general and lacking in important details included in the section as now drafted, it is strongly urged that the effective date for this section be changed to at least the August 1st date of the introduction of the bill in the House of Representatives and, preferably, to the date when the Tax Reform Act of 1969 is passed by both houses of Congress and signed by the President.

The issuance of the May 27 press release does not justify making § 411 effective as of that date, for the section, even in its present form, is substantially different from what was outlined in the press release and will presumably change still further if it is to be enacted.

The May 27 press release indicated that the $5 million exemption was a flat exemption without reductions; the bill, on the other hand, would reduce the exemption in such a way that it would be virtually meaningless for many companies.

The press release indicated a debt-equity test, presumably based on fair market values; but the bill, on the other hand, would use adjusted basis tax figures in determining the equity, which could produce radically different results.

The press release indicated that "earnings," presumably in the normal financial sense, would be used in connection with the earnings coverage test. The bill would use, instead, the very specialized tax concept of "earnings and profits," a radically different thing in many cases. For example, the additional deductions from income attributable to the use of accelerated depreciation reduce "earnings and profits," but may not reduce "earnings."

The press release indicated that combined earnings of the acquired and acquiring companies would be used in connection with the earnings coverage test, but the bill would use combined earnings *only* if there is an acquisition of control, i.e., 80% of the stock or substantially all the assets.

Corporate transactions which would be affected by the bill were underway throughout the period of consideration of the various forms of § 411 and its legislative predecessors and the discussion of their desirability. Such transactions, often major, should not be caught in the web of a half-completed and half-considered bill. Rather, there should be fair and full disclosure of the applicable rules of such a basic and far-reaching change in Federal tax policy prior to its taking effect.

The next witness is Mr. Sidney Kess, national director of taxes, Main Lafrentz & Co.

STATEMENT OF SIDNEY KESS, NATIONAL DIRECTOR OF TAXES, MAIN LAFRENTZ & CO.; ACCOMPANIED BY NEIL WASSNER

Mr. KESS. My name is Sidney Kess. I am a certified public accountant and a partner of Main Lafrentz & Co., an international firm of certified public accountants with headquarters in New York City. I should also like to introduce Neil Wassner, who is a certified public acountant and a manager in our firm, specializing in acquisition work. Our firm has had many years of experience in advising its clients respecting the financial aspects of mergers and acquisitions, including, of course, the tax implications thereof. On the basis of this experience we feel that our comments regarding the proposal to disallow the deduction of interest incurred on certain types of debt used to finance acquisitions would be of value to the committee.

No one will deny that the desirability of mergers is a question of deep social, economic and even political significance. Many authorities feel that conglomerates may well represent a fresh wind of change blowing through the established business community which redounds to the benefit of all because of increased efficiency in asset management. However, whether or not you are in accord with this view should not affect your judgment as to the propriety of amending the Internal Revenue Code in order to cope with this problem.

We believe that the proposed approach to acquisition activity constitutes an improper and dangerous use of the taxing power.

You are all aware, as you pointed out, Mr. Chairman, of the investigation being conducted by the Antitrust Subcommittee of the House Judiciary Committee under the chairmanship of Congressman Celler to gather evidence with respect to conglomerate mergers, on the basis of which corrective legislation will be proposed. You are also familiar with the current efforts by the Department of Justice and Federal Trade Commission to apply existing legislation in dealing with antitrust problems arising in connection with mergers. Therefore, the social and economic effects of mergers are already receiving adequate attention from those branches of the Government which possess the requisite expertise.

Moreover, there were those who had claimed that investors were being duped by "funny money" debt securities issued in acquisitions. Such complaints are also receiving expert attention from those responsible for the self-regulation of the securities industry. As you know, officials of major stock exchanges have refused to list debentures when projections of postacquisition earnings indicated interest would absorb virtually all net operating earnings. If these efforts are deemed to be insufficient, the Securities and Exchange Commission could take steps to deal with disclosure and other aspects of the question within its jurisdiction. Therefore, it is evident that such problems as may exist can be dealt with adequately within the appropriate framework, and that the tax law is not a necessary weapon in any attack upon conglomerates which may be deemed necessary.

Everyone concedes that conglomerate mergers, per se, are neither good nor bad when measures within the framework of their effect on the economy. Yet the express purpose of section 411 is to curb conglomerate mergers. Is it not striking that the tax law is to be used as a means of branding mergers as malum in se, without recourse to any standards of evaluation perfected by economists or the marketplace?

Ideally the tax law should be neutral. It should neither promote mergers nor discourage them, because the tax law cannot differentiate between healthy and unhealthy mergers with respect to competition.

It has been said that the tax law promotes debt-financed mergers by allowing the deduction of interest on debt used to finance the acquisition. This observation touches upon but the tip of the iceberg. All interest is deductible, and accordingly debt-financed internal expansion may also, under this theory, be said to be favored over expansion through issuance of additional equity securities. Why should a debt instrument be treated as equity when used for external expansion but be treated as debt when used to finance internal expansion?

It can also be said that the "reorganization" sections of the code encourage equity-financed acquisitions by postponing the tax on any gain realized by the acquired company's shareholders. The effect of any theoretical "push" toward equity resulting from the reorganization sections, is offset by the theoretical "push" toward debt resulting from the interest deduction. Therefore, at the threshold there is a standoff and thus at present the code can truly be said to be neutral with respect to acquisitions.

Let us now analyze whether proposed section 411 would operate effectively. We submit that the tests it prescribes are based on misconceptions and misunderstandings of the financial facts of life. In brief, section 411 proposed to disallow interest on subordinated convertible debt (or subordinated debt issued with warrants) if a debt to equity ratio and earnings coverage test are not met.

At the outset it should be pointed out that the technique of disallowance of interest reflects the mistaken belief of the proponents of this measure that debt is issued in acquisitions to improve earnings per share of common stock, because interest is deductible whereas preferred dividends are not. In reality, the converse is often true. As a result of an accounting concept known as "pooling of interests" the book value—not the fair market value—of assets acquired may be recorded on the books of the acquiring company provided that equity constitutes the bulk of the consideration. In other words, you are picking up the assets at book value when you have a pooling of interest.

Therefore, taxpayers frequently forgo the benefits of a higher tax basis of the acquired company, and higher depreciation or amortization deductions which would result from debt-financed acquisitions, and issue stock in order to maximize earnings per share by using lower "carried over" book values and correspondingly lower depreciation and amortization deductions in computing income.

Convertible debt will be tainted under section 411. Such a blanket characterization as quasi-equity is erroneous; it overlooks the fact that the relationship of the underlying conversion price to principal amount is the true test. If the conversion price is at or near current market then there may be grounds for equating the debt in some respects, as an economic matter, with preferred stock. However, if the conversion price is substantially below market there is no doubt that the instrument is debt in every sense of the word. The bill does not recognize this critical standard of measurement. It may be noted in passing that convertible debt is characteristically issued at a much lower interest rate than straight debt, and therefore results in lower tax deductions; yet it is convertible debt which section 411 attacks.

Over the years the courts have developed several basic criteria which are used in evaluating instruments that purport to be debt, but which the Internal Revenue Service claims are equivalent to stock interests. Section 411 prescribes two tests which are to be applied to determine whether interest on acquisition indebtedness shall be disallowed; both are contrary to the ground rules developed by the courts. The debt to equity ratio is to be calculated on the basis of tax cost, or what we may loosely describe as the depreciated cost of the taxpayer's assets. Yet the courts look to the portion of the value of the company which is represented by debt to determine when it is truly quasi-equity and do not measure its relation to costs reflected on the balance sheet. Furthermore, under the proposed test, ironically, an "acquisition-minded" company might possess an advantage over a company that has grown internally. This would result from the fact that goodwill and other intangibles are assets which may be recorded on the books of one taxpayer if they were acquired from another entity, but which may not be reflected on the books of another if they were created through internal efforts. This is an accounting concept where we wouldn't be picking up the good will if it were created internally.

Now, any remaining significance of the debt to equity ratio test is further diminished by the fact that differences in accounting methods, with respect to matters such as depreciation and the writeoff of research and development costs will result in two companies of equal strength faring differently under the test.

The CHAIRMAN. I would suggest you conclude your statement. I have read it and I think most of our members have. Our procedure here really is to ask witnesses to summarize their statements.

Mr. KESS. Yes; sir.

Just one last observation. I have been teaching thousands of accountants and practitioners around the country and the thing that has hit me is laws are being written that very often we assume that practitioners understand everything that is going on, and when we add on eight more new pages in a code to deal with a small problem we are certainly complicating the whole tax structure and adding more problems for its administration.

Thank you, Mr. Chairman, for the opportunity of making this statement.

The CHAIRMAN. Thank you.

(Sidney Kess' prepared statement follows:)

STATEMENT OF MR. SIDNEY KESS, PARTNER, ACCOMPANIED BY MR. NEIL WASSNER, MANAGER, MAIN LAFRENTZ & CO.

We fell that proposed Section 411 should not be adopted for three principle reasons.

First, it is our feeling that the section is an improper use of the taxing power. The evils that it seeks to cure could more effectively be overcome through the antitrust statutes or the securities acts. This Section would topply the delicate neutrality respecting mergers of the existing tax statute.

Second, we feel that proposed Section 411 utilizes incorrect standards in differentiating tainted debt from non-tainted debt. The debt to equity ratio and earnings coverage tests fly in the face of long established court decisions used to make this differentiation. The application of these ratios would work with an uneven hand since mere difference in accounting methods between similar companies could lead to dramaitc differences in how they could acceptably finance a merger.

Finally, we think that the proposed Section would add another extremely complex and unnecessary provision to an already over-complicated Internal Revenue Code. The addition of such provisions inevitably leads to breakdowns in compliance and administration.

STATEMENT

My name is Sidney Kess. I am a Certified Public Accountant and a Partner of Main Lafrentz & Co., an international Firm of Certified Public Accountants with headquarters in New York City. I should also like to introduce Neil Wassner, who is a Certified Public Accountant and a Manager in our Firm, specializing in acquisition work. Our Firm has had many years of experience in advising its clients respecting the financial aspects of mergers and acquisitions, including, of course, the tax implications thereof. On the basis of this experience we feel that our comments regarding the proposal to disallow the deduction of interest incurred on certain types of debt used to finance acquisitions would be of value to the Committee.

Improper use of taxing power

No one will deny that the desirability of mergers is a question of deep social, economic and even political significance. Many authorities feel that conglomerates may well represent a fresh wind of change blowing through the established business community which rebounds to the benefit of all, because of increased efficiency in asset management. However, whether or not you are in accord with this view should not affect your judgment as to the propriety of amending the Internal Revenue Code in order to cope with this problem.

We believe that the proposed approach to acquisition activity constitutes an improper and dangerous use of the taxing power.

You are all aware of the investigation being conducted by the Antitrust Subcommittee of the House Judiciary Committee under the Chairmanship of Congressman Celler to gather evidence with respect to conglomerate mergers, on the basis of which corrective legislation will be proposed. You are also familiar with the current efforts by the Department of Justice and Federal Trade Commission to apply existing legislation in dealing with antitrust problems arising in connection with mergers. Therefore. the social and economic effects of mergers are already receiving adequate attention from those branches of the government which possess the requisite expertise.

Moreover, there were those who had claimed that investors were being duped by "funny money" debt securities issued in acquisitions. Such complaints are also receiving expert attention from those responsible for the self-regulation of the securities industry. As you know, officials of major stock exchanges have refused to list debentures when projections of post-acquisition earnings indicated interest would absorb virtually all net operating earnings. If these efforts are deemed to be insufficient, the Securities and Exchange Commission could take steps to deal with disclosure and other aspects of the question within its jurisdiction. Therefore, it is evident that such problems as may exist can be dealth with adequately within the appropriate framework, and that the tax law is not a necessary weapon in any attack upon conglomerates which may be deemed necessary.

Everyone concedes that conglomerate mergers, per se, are neither good nor bad when measured within the framework of their effect on the economy. Yet the express purpose of Section 411 is to curb conglomerate mergers. Is it not striking that the tax law is to be used as a means of branding mergers as *malum in se,* without recourse to any standards of evaluation perfected by economists or the market place?

Ideally the tax law should be neutral. It should neither promote mergers nor discourage them, because the tax law cannot differentiate between healthy and unhealthy mergers.

It has been said that the tax law promotes debt-financed mergers by allowing the deduction of interest on debt used to finance the acquisition. This observation touches upon but the tip of the iceberg. All interest is deductible, and accordingly debt financed internal expansion may also, under this theory, be said to be favored over expansion through issuance of additional effuity securities. Why should a debt instrument be treated as equity when used for external expansion but be treated as debt when used to finance internal expansion?

It can also be said that the "reorganization" sections of the Code encourage equity-financed acquisitions by postponing the tax on any gain realized by the acquired company's shareholders. The effect of any theoretical "push" toward equity resulting from the reorganization sections, is offset by the theoretical "push" toward debt resulting from the interest deduction. Therefore, at the threshold there is a stand-off, and thus at present the Code can truly be said to be neutral with respect to acquisitions.

Section 411 utilizes incorrect standards

Let us now analyze whether proposed Section 411 would operate effectively. We submit that the tests it prescribes are based on misconceptions and misunderstandings of the financial facts of life. In brief, Section 411 proposes to disallow interest on subordinated convertible debt (or subordinated debt issued with warrants) if a debt to equity ratio and earnings coverage test are not met.

At the outset it should be noted that the technique of disallowance of interest reflects the mistaken belief of the proponents of this measure that debt is issued in acquisitions to improve earnings per share of common stock, because interest is deductible whereas preferred dividends are not. In reality, the converse is often true. As a result of an accounting concept known as "pooling of interests" the book value (not the fair market value) of assets acquired may be recorded on the books of the acquiring company provided that equity constitutes the bulk of the consideration. Therefore, taxpayers frequently forego the benefits of a higher tax basis and higher depreciation or amortization deductions which would result from debt financed acquisitions, and issue stock in order to maximize earnings per share by using lower "carried over" book values and correspondingly lower depreciation and amortization deductions in computing income.

Convertible debt will be tainted under Section 411. Such a blanket characterization as quasi-equity is erroneous; it overlooks the fact that the relationship of the underlying conversion price to principal amount is the true test. If the conversion price is at or near current market then there may be grounds for equating the debt in some respects, as an economic matter, with preferred stock. However, if the conversion price is substantially below market there is no doubt that the instrument is debt in every sense of the word. The Bill does not recognize this critical standard of measurement. It may be noted in passing that convertible debt is characteristically issued at a much lower interest rate than straight debt, and therefore results in *lower* tax deductions; yet it is convertible debt which Section 411 attacks.

Over the years the courts have developed several basic criteria which are used in evaluating instruments that purport to be debt, but which the Internal Revenue Service claims are equivalent to stock interests. Section 411 prescribes two tests which are to be applied to determine whether interest on acquisition indebtedness shall be disallowed; both are contrary to the ground rules developed by the courts. The debt to equity ratio is to be calculated on the basis of tax cost, or what we may loosely describe as the depreciated cost of the taxpayer's assets. Yet the courts look to the portion of the value of the company which is represented by debt to determine when it is truly quasi-equity and do not measure its relation to costs reflected on the balance sheet. Furthermore, under the proposed test, ironically, an "acquisition-minded" company might possess an advantage over a company that has grown internally. This would result from the fact that goodwill and other intangibles are assets which may be recorded on the books of one taxpayer if they were acquired from another entity, but which may not be reflected on the books of another if they were created through internal efforts.

Any remaining significance of the debt to equity ratio test is further diminished by the fact that differences in accounting methods, with respect to matters such as depreciation and the write-off of research and development costs will result in two companies of equal strength faring differently under the test. Many companies will suffer from the fact that their assets were rapidly written off for tax accounting purposes. Thus, it is obvious that tax cost as a measure of debt/equity ratio is wrong as a matter of law and reason. To use value, however, opens Pandora's box. Therefore, it is apparent that this test should be jettisoned.

The projected earnings coverage test like the debt/equity ratio test is also contrary to the approach set forth in numerous court decisions. Section 411 would look at the past and freeze the characterization of debt on that basis. The courts, however, have looked at earnings during the period the debt is outstanding. It certainly would be illogical to penalize a transaction which leads to revitalization of an ailing company by a denial of interest deductions on account of past poor performance. In addition, the earnings coverage test measures average historical earnings against "interest to be paid or incurred on total outstanding indebtedness." You are all familiar with what is colloquially referred to as "off-balance sheet financing," *i.e.*, the use of long-term lease commitments as a financing alternative to the purchase of necessary assets with borrowed funds. A company which pays substantial lease rentals (which are the economic equivalent of debt service) would not take into account disquised interest costs in determining coverage under Section 411, whereas a taxpayer whose management chose direct financing would be required to include interest on such debt for that purpose. Again, taxpayers otherwise equal in financial ability would be treated differently under Section 411 as a result of management decisions and business considerations wholly unrelated to the merger in question. Furthermore, we would be faced again with the uneven treatment of otherwise similarly situated taxpayers who have adopted different methods of accounting for depreciation, inventory and various other items, and thus show widely differing earnings.

Complexity

Over the past five years I have lectured to thousands of accountants seeking to improve their command of the already complex Internal Revenue Code. My experience has demonstrated that it is difficult for the practitioner to grasp and retain the myraid of fundamentals contained therein. Section 411, directed at one *non-tax* problem, comprises eight pages of the House Bill. This type of additional complexity should be avoided at all cost when there is a far better alternative, as in this case. Such complexity can only lead inevitably to a breakdown in compliance and administration.

Conclusion

The task of controlling conglomerage mergers is within the province of the antitrust and securities law. It is not one which should be engrafted into the Internal Revenue Code and enforced by revenue agents. The tests incorporated in Section 411 are incorrect, and unrealistic and will operate unfairly as between similarly situated taxpayers. Accordingly, we respectfully submit that the proposed Section be dropped.

We thank the Committee for the opportunity of making this statement.

The CHAIRMAN. I would like to say this to our witnesses. Our procedure here does have to follow the Reorganization Act. That is the only way we will conclude the thousands of pages of testimony we are taking on this bill in 5 weeks. Each witness is invited to submit a summary of the points he wishes to make in his statement. We also have our own staff summarize it for us, which is available to each Senator. We do not wish witnesses to read their prepared statements. We want them to summarize those statements. We will take the responsibility of reading them, and together with our staff we will see that each point that they make is fully considered when the committee does meet in executive session.

Now, the next witness is Mr. T. M. Evans, chairman of the Crane Co.

Senator CURTIS. Mr. Chairman, at this point could I make a request for some material to go into the record. I would like to have the staff prepare an analysis of the House-passed bill which would do this: It would set forth in one column those provisions and describe them in not to to exceed two sentences or a sentence or two that would increase the revenue and how much. Then to set forth in another column those provisions of the bill with a similar brief description that would lessen the revenue, and then in a third column those provisions of the House-passed bill which would not affect revenue and, of course, in the first two lists I would like to have them totaled.

(The following material was subsequently supplied for the record:)

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	A. PRIVATE FOUNDATIONS	
1. Tax on investment income (+65, +100).—A tax of 7½ percent is imposed on a private foundation's net investment income (interest, dividends, rents, and royalties) and net capital gains.		
	2. Prohibition on self-dealing.—Self-dealing between a donor (or related parties) and his private foundation is prohibited. Self-dealing is generally a transfer of money or property between a foundation and a donor other than gifts by the donor. A 3-level set of sanctions (taxes) is imposed on violations.	
	3. Distributions of income.—Private nonoperating foundations must distribute all their income currently (but not less than 5 percent of their investment assets) except in certain circumstances. Graduated sanctions (taxes) are imposed for failure to make timely distributions.	
	4. Stock-ownership limitation.—The combined ownership of a corporation's voting stock which can be held by a foundation and all disqualified persons is limited to 20 percent (or 35 percent if someone else has control of the business). Existing excess holdings must be disposed of within 10 years (with interim requirements at 2 and 5 years).	
	5. Limitations on use of assets.—Any investment made by a private foundation which is made in such a manner as to jeopardize the carrying out of the foundation's exempt purpose is subject to a 100-percent tax. (Under present law, a private foundation loses its exemption if its accumulated income is invested in such a manner.)	
	6. Other limitations.—Private foundations are forbidden to spend money for lobbying, electioneering (including voter registration drives except when conducted on a nonpartisan basis by broadly supported, widely active organizations), grants to individuals not made on an objective basis, grants to other foundations (unless the granting foundation accepts certain responsibilities), and for any other noncharitable purpose.	
	7. Disclosure and publicity requirements.—The requirement for filing information returns available to public inspection is extended to religious and publicly supported charitable organizations (except where the Treasury determines this is not necessary for efficient tax administration) and requires that additional information as to donors, management officials, and highly paid employees be included on the return.	

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued
[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	A. PRIVATE FOUNDATIONS—Continued	
	8. Change of status.—New exempt organizations must notify the IRS if they claim to be exempt under 501(c)(3) and new and existing organizations exempt under 501(c)(3) must notify the IRS if they claim they are not private foundations. If a private foundadation seeks to change its status or the IRS determines that it has committed repeated willful violations, then the organization must repay to the Government the aggregate income, estate, and gift tax benefits (with interest) that have flowed to the foundation and all its substantial donors since 1913 from the foundation's exempt staus unless the organization distributes all its assets to public charities or itself acts as a public charity for 5 years.	
	9. Change in definitions.—A "private foundation" is any organization described in section 501(c)(3) other than: (1) organizations, contributions to which may be deducted to the extent of 30 percent of an individual's income; (2) certain types of broadly publicly supported organizations (including membership organizations); (3) those which are, in effect, instrumentalities of organizations described in (1) or (2).	
	10. Private operating foundation definition.—An "operating foundation" is an organization substantially all of the income of which is expended directly for the active conduct of its exempt purposes provided that either (1) substantially more than half its assets are devoted to such activities, or (2) substantially all its support (other than from endowment) is normally received from at least 5 independent exempt organizations and from the general public.	
	11. Hospitals.—Hospitals are to have the same status as churches and educational institutions for purposes of tax exemptions, charitable contributions, and a variety of other matters whether or not they provide a significant amount of charitable services on a no-cost or low-cost basis provided they meet the the other requirements of 501(c)(3).	
	12. Effective dates.—The above changes generally apply to taxable years beginning after Dec. 31, 1969, except that additional time is permitted in the case of existing organizations to reform their governing instruments to conform to the new law as to business holdings and distributions of income, and the 5-percent minimum distribution requirement will not apply to them until 1972.	

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	B. OTHER TAX-EXEMPT ORGANIZATIONS	
1. The "Clay Brown" provision or debt-financed property.—All exempt organizations' income is to be subject to tax in the proportion the property is financed by debt except for property to be used for an exempt purpose within a reasonable time and certain other types of property.		
2. Extension on unrelated business income tax to all exempt organizations.—The unrelated business income tax is extended to the income from business activities which are regularly carried on by exempt organizations which are presently not subject to the tax, including churches, social welfare organizations, social groups, fraternal beneficiary societies, employees' beneficiary associations, etc.		
3. Taxation of investment income of social, fraternal, and similar organizations.—The corporate income tax is imposed on the investment income and other unrelated income of social clubs, fraternal and employees' beneficiary associations (except for income set aside by fraternal and employees' beneficiary associations for the exempt insurance function or charitable purposes).		
4. Interest, rents, and royalties from controlled corporations.—Where an exempt organization owns more than 80 percent of a taxab subsidiary, interest, annuities, royalties and rents are to be treated as "unrelated business income" and subject to tax.		
5. Limitation on deductions of nonexempt membership organizations.—In the case of taxable membership organizations, the deduction for expenses incurred in supplying services, facilities or goods to members is allowed only to the extent of the income from such members.		
6. Income from advertising, etc.—Income from advertising (or a similar activity) is included in unrelated business income even though the advertising is carried on in connection with activities related to the exempt purpose.		
The revenue gain from the above provisions applicable to other tax-exempt organizations is (+5, +20).		
	C. CHARITABLE CONTRIBUTIONS	
		1. 50-percent charitable deduction limitation (−20, −20).—The 30-percent limit on charitable contributions is increased to 50 percent except that contributions of appreciated property, which, if sold, would be treated as capital gains, remain subject to the 30-percent limitation.

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	C. CHARITABLE CONTRIBUTIONS—Continued	
2. Repeal of the unlimited deduction (+10, +25).—The unlimited charitable contribution deduction is eliminated for years beginning after 1974. During the interim period, an increasing limitation is imposed on the amount by which the deduction can reduce an individual's taxable income.		
3. Charitable contributions of appreciated property (+15, +15).—In the case of charitable contributions of appreciated property, either to a private nonoperating foundation or of specified types of property, the taxpayer has the option (a) of reducing his deduction to the amount of his cost or other basis for the property, or (b) taking a deduction for the fair market value of the property and including the appreciation in income.		
	4. 2-year charitable trust.—The rule under which an individual is not taxed on the income from property which he transfers to a trust to pay the income to charity for a period of at least 2 years is eliminated.	
	5. Charitable contributions for estates and trusts.—The charitable contribution deduction is eliminated for amounts set aside for, but not paid out to, charitable organizations by nonexempt trusts.	
	6. Gifts of the use of property.—The charitable deduction for the contribution of the right to use property for a period of time is eliminated.	
	7. Charitable remainder trusts.—The charitable contribution deduction in the case of a charitable gift of a remainder interest in trust is limited to situations where there is a close correlation between the amount to be received by charity and the amount of the deduction allowed when the trust is created.	
	8. Charitable income trust with noncharitable remainders.—A charitable contribution deduction is not to be allowed where a person gives an income interest to charity in trust unless he is taxable on the trust income and the charity is to receive a fixed dollar or percentage amount.	
	D. FARM LOSSES	
1. Gains from dispositions of property used in farming where farm losses offset nonfarm income.—If a taxpayer uses the cash accounting method and has more than $50,000 of nonfarm income, farm losses in excess of $25,000 are placed in an excess deduction account (EDA) and capital capital gains on the sale of farm property are converted to ordinary income to the extent of amounts in the EDA.		

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	D. FARM LOSSES—Continued	
2. Depreciation recapture.—The present exception for livestock from the depreciation recapture rules which treats the gain on the sale of personal property used in a business as ordinary income, rather than capital gain, to the extent of depreciation claimed on the property is eliminated.		
3. Holding period for livestock.—The required holding period for capital gains treatment in the case of livestock held for draft, breeding, dairy and sporting purposes is extended to a period of 1 year after the animal normally would have been used for such purposes.		
The revenue gain from the above 3 farm provisions is (less than +2.5, +20).		
	4. Hobby losses.—The present hobby loss provision is replaced by a rule which disallows the deduction of losses from an activity carried on by the taxpayer where the activity is not carried on with a reasonable expectation of profit.	
	E. LIMIT ON DEDUCTION OF INTEREST (+20, +20)	
In the case of individuals, the deduction for interest on funds borrowed for investment purposes is limited to the individual's net investment income and long-term capital gains plus $25,000. Amounts disallowed could be carried over to subsequent years subject to the limitation		
	F. MOVING EXPENSES (−100, −100)	
		The present duduction for moving expenses is extended to include expenses for: (1) pre-move house-hunting trips, (2) temporary living expenses at the new job location, and (3) certain expenses incident to the disposition or acquisition of a residence at the old and new locations. An overall limitation of $2,500 is imposed and (2) plus (3) may not exceed $1,000.
	G. LIMIT ON TAX PREFERENCES (+40, +85)	
A limit on tax preferences (LTP) is provided under which an individual must include in income ½ of the amount of his tax preferences which exceed the amount of his adjusted gross income. The tax preferences are: (1) tax-exempt interest (taken into account over a 10-year period), (2) excluded capital gains, (3) appreciation on charitable gifts, (4) the excess of accelerated over straight line depreciation on real property, and (5) farm losses which result from cash accounting. A 5-year carryover is provided for disallowed preferences.		

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars ,for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	H. ALLOCATION OF DEDUCTIONS (+205, +460)	
An individual must allocate his personal deductions between tax preferences and income subject to tax, resulting in a disallowance of the proportion of itemized deductions which tax preferences bear to total income including tax preferences. Tax preferences are the same as those under LTP except that tax-exempt interest on bonds outstanding is not taken into account and a portion of intangible drilling expenses and the excess of percentage over cost depletion are included.		
	I. INCOME AVERAGING (−300, −300)	
		The $133\frac{1}{3}$ percent by which a taxpayer's taxable income must exceed his average taxable income for the prior 4 years to be eligible for averaging is reduced to 120 percent and capital gains and certain other types of income are made eligible for averaging.
	J. RESTRICTED PROPERTY (LESS THAN +2.5, +2.5)	
	A person who received compensation in the form of property such as stock which is subject to a restriction generally is subject to tax on the unrestricted value of the property at the time of receipt, unless his interest is subject to a substantial risk of forfeiture in which case he is taxed when the risk of forfeiture is removed.	
	K. OTHER DEFERRED COMPENSATION (LESS THAN +2.5, +25)	
The tax on deferred compensation is to continue to be deferred until the time the compensation is received, but a minimum tax is to be imposed on certain deferred compensation in excess of $10,000 received in any year.		
	L. ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC. (+50, +70)	
In the case of accumulation trusts (including multiple trusts) the beneficiary of the trust generally is to be taxed on distributions of accumulated income in approximately the same manner as if he had received the income when it was earned by the trust.		
	M. MULTIPLE CORPORATIONS (+20, +235)	
A controlled group of corporations is to be gradually limited over an 8-year period to one $25,000 surtax exemption and limitations are imposed on the multiple use of other provisions designed to aid small businesses.		
	N. CORPORATE MERGERS	
1. Disallowance of interest deduction in certain cases (+10, +70).—A deduction is disallowed for interest on bonds issued by a corporation in connection with the acquisition of stock or at least $\frac{2}{3}$ of the assets of another corporation where the bonds have specified characteristics which make them more closely akin to equity.		

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	N. CORPORATE MERGERS—Continued	
	2. Limitation on installment sales provision.—Bonds, in registered form, with interest coupons attached or which are readily marketable are to be considered payments in the year of sale for purposes of the installment method. The installment method is not to be available unless the payments of principal and interest are spread relatively evenly over the installment period.	
	3. Original issue discount.—A bondholder must include the original issue discount in income ratably over the life of the bond.	
	4. Convertible indebtedness repurchase premiums.—A corporation which repurchases its convertible indebtedness at a premium may deduct as interest only that part of the premium which represents a cost of borrowing rather than being attributable to the conversion feature.	
	O. STOCK DIVIDENDS (LESS THAN +2.5, +2.5)	
	A stock dividend is to be taxable if one group of shareholders receives a disproportionate distribution in cash and there is an increase in the proportionate interest of other shareholders in the corporation.	
	P. FOREIGN TAX CREDIT	
1. Foreign losses (+35, +35).—A taxpayer who uses the per country limitation on the foreign tax credit and who reduces his tax on domestic income by reason of a loss from a foreign country is to have the resulting tax benefit recaptured when income is subsequently derived from that country.		
2. Foreign tax-royalties (+30, +30).—A separate foreign tax credit limitation is provided in the case of foreign mineral income where the foreign government also holds mineral rights so that excess credits from this source cannot be used to reduce U.S. tax on other foreign income.		
	Q. FINANCIAL INSTITUTIONS	
1. Commercial banks—reserves for losses on loans (+250, +250).—In the future, the deduction allowed commercial banks for additions to bad debt reserves is to be limited to the amount called for on the basis of their own loss experience.		
2. Mutual savings banks, savings and loan associations, etc. (+10, +170).—The bad debt reserve provisions are modified by eliminating the 3 percent method and reducing the present 60-percent method to 30 percent gradually over 10 years. The special deduction is to be allowed only if the institution has a prescribed percentage of its investments in residential real property loans and other specified types of investments.		

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	Q. FINANCIAL INSTITUTIONS—Continued	
3. Treatment of bonds held by financial institutions (+50, +50). Financial institutions are to treat net gains from the sale of bonds as ordinary income instead of as capital gains and will continue to treat net losses from such sales as ordinary losses.		
	4. Foreign deposits in U.S. banks.—The expiration date for the special income tax and estate tax rules regarding U.S. bank deposits of foreign persons is extended from 1972 to 1975.	
	R. DEPRECIATION ALLOWED REGULATED INDUSTRIES	
1. Accelerated depreciation (+60, +310). Regulated utilities are, in general, "frozen" as to their depreciation practices including whether they use straight line or accelerated depreciation and whether they normalize or flow through the tax benefits of accelerated depreciation.		
2. Earnings and profits (0, +80).—Corporations must compute earnings and profits (which determine whether dividends are taxable or not) on the basis of straight line depreciation.		
S. ALTERNATIVE CAPITAL GAIN RATE FOR CORPORATIONS (+175, +175)		
The alternative capital gains rate applied to a corporation's net long-term capital gain is increased from 25 to 30 percent.		
	T. NATURAL RESOURCES	
1. Percentage depletion (+425, +400).—The percentage depletion rate for oil and gas wells is reduced from 27.5 to 20 percent and the rates for all other minerals are comparably reduced except in the case of gold, silver, oil shale, copper and iron ore from domestic sources. Percentage depletion on foreign oil and gas wells is eliminated.		
2. Mineral production payments (+100, +200).—Carved-out payments and retained payments (including ABC transactions) are to be treated as a loan by the owner of the production payment to the owner of the mineral property.		
	3. Mining exploration expenditures.—The general rule of present law under which mining exploration expenditures are recaptured when a mine reaches the producing stage is extended to foreign and oceanographic exploration.	
	4. Treatment processes in case of oil shale.—The percentage depletion cutoff point for oil shale is extended through retorting.	

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	U. CAPITAL GAINS AND LOSSES	
1. Alternative tax (+360, +360).—The 25-percent alternative tax rate applicable to net long-term capital gains in the case of individuals is eliminated.		
2. Capital losses of individuals (+50, +65).—The amount of an individual's net long-term capital losses that can be offset against ordinary income is limited to 50 percent of such losses.		
	3. Collections of letters, memorandums, etc. (less than +2.5).—Letters, memorandums and similar property are to be treated as ordinary income rather than capital gain property in the hands of the person who created them or for whom they were prepared.	
4. Holding period of capital assets (+100, +150).—The holding period which must be satisfied for a gain on property to be considered a long-term gain is increased from 6 to 12 months.		
5. Total distributions from qualified pension, etc., plans (less than +2.5, +50).—Present capital gains treatment accorded lump sum distributions from qualified employee pension, profit sharing, stock bonus or equity plans is limited to the amount of the distribution in excess of the employer's contribution. The employer contribution will be treated as ordinary income subject to a special 5-year forward averaging rule.		
6. Sales of life estates, etc. (+10, +10).—The entire amount received on the sale of a life estate in property acquired by gift, bequest, or inheritance is to be taxable rather than only the excess of the amount received over the seller's basis for his interest.		
	7. Certain casualty losses under sec. 1231 (less than +2.5).—Casualty losses and casualty gains are to be consolidated in determining whether they give rise to an ordinary loss or to gains which are consolidated with other section 1231 gains and losses.	
	8. Transfers of franchises (less than +2.5).—Transfers of franchises are to be treated as giving rise to ordinary income rather than capital gains if the transferor retains any significant power, right, or continuing interest concerning the subject matter of the franchise.	
	V. REAL ESTATE DEPRECIATION	
1. Restriction on use of accelerated depreciation (+15, +1,210).—The most accelerated methods of real estate depreciation (200 percent declining balance and the sum-of-the-years digits methods) are limited to new residential housing. Other new real estate is limited to the 150 percent declining balance method. Only straight line depreciation is available in the case of used buildings.		

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue aining	No appreciable revenue effect	Revenue losing
	V. REAL ESTATE DEPRECIATION—Continued	
2. Recapture of excess depreciation (+5, +125).—Gain on the sale of real property will be treated as ordinary income rather than as capital gain to the extent of the excess of accelerated over straight line depreciation.		
		3. Rehabilitation of rental housing (−15, −330).—A special 5-year amortization deduction is provided for expenditures for the rehabilitation of low cost rental housing.
	W. COOPERATIVES (LESS THAN +2.5)	
	Cooperatives are required to revolve out patronage dividend and per unit retain allocations within 15 years, and the percentage of patronage allocations which must be paid out currently in cash is increased from 20 to 50 percent.	
	X. SUBCHAPTER S CORPORATIONS (LESS THAN +2.5)	
	For subchapter S corporations, the amounts set aside under qualified employee pension plans for shareholder-employees of the corporation must be included in the income of the shareholder-employee to the extent the contribution exceeds 10 percent of his salary or $2,500 whichever is less.	
	Y. TAX TREATMENT OF STATE AND MUNICIPAL BONDS	
	State and local governments are given the voluntary election to issue taxable bonds. If they make this choice, the Federal Government will pay between 30 and 40 percent of the interest on the bond (between 25 and 40 percent for years after 1974).	
	Z. EXTENSION OF TAX SURCHARGE AND EXCISE TAXES AND TERMINATION OF THE INVESTMENT CREDIT	
1. Extension of tax surcharge at 5-percent rate for first half of 1970 (+3, 100,—).—The income tax surcharge is extended at a 5-percent rate from Jan. 1, 1970, through June 30, 1970.		
2. Continuation of excise taxes on communication services and automobiles (+1,170,—).—The presently scheduled reductions in the 7-percent excise tax on automobiles and 10 percent tax on telephone services to 5 percent in 1970, 3 percent in 1971, 1 percent in 1972, and the repeal in 1973, are postponed for 1 year.		
3. Repeal of the investment credit (+2,500, +3,300).—The investment credit is permanently repealed for property acquired or on which construction was begun after April 18, 1969, unless carried out pursuant to a binding contract in effect before Apr. 19, 1969. The available credit is phased out gradually until 1975 and a 20-percent limit is placed on the use of carryover of unused credits.		
		4. Amortization of pollution control facilities (−40, −400).—A taxpayer will be allowed to amortize over a period of 60 months any new certified air or water pollution control facility constructed after 1968.

REVENUE EFFECT OF THE PROVISIONS OF H.R. 13270, THE TAX REFORM ACT OF 1969—Continued

[Amounts in millions of dollars, for 1970 and 1979, respectively]

Revenue gaining	No appreciable revenue effect	Revenue losing
	Z. EXTENSION OF TAX SURCHARGE—Continued	
		5. Amortization of certain railroad rolling stock (less than −2.5, −100).—Railroads subject to regulation by the ICC may amortize over 7 years rolling stock (except locomotives) put into original use after July 31, 1969.
	AA. ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS	
		1. Increase in the standard deduction (−867, −1,373).—The 10 percent standard deduction with a $1,000 ceiling is increased to 13 percent with a $1,400 ceiling in 1970, 14 percent with a $1,700 ceiling in 1971, and 15 percent with a $2,000 ceiling in 1972.
		2. Low income allowance (−625, −2,652).—The present minimum standard deduction of $200 plus $100 for each exemption with a $1,000 limit is replaced with a low income allowance of $1,100. In 1970 only, the excess of the low income allowance over the present minimum standard deduction is reduced by $1 for each $2 that the taxpayer's income exceeds the new nontaxable income level.
		3. Maximum tax on earned income (−200, −100).—The maximum marginal rate applicable to an individual's earned income is not to exceed 50 percent.
		4. Intermediate tax rates, surviving spouse treatment (—, −650).—Widows and widowers and unmarried individuals age 35 or over are provided a rate schedule halfway between the rates applicable to other single persons and those applicable to joint returns (the former head-of-household treatment). A widow or widower with a dependent child may use the joint return schedule indefinitely rather than for the two years after the spouse's death provided in present law.
		5. Individual income tax rates (—, −4, 498).—All tax rates are reduced by at least 1 percentage point, the top 70-percent rate is reduced to 65 percent, and in all brackets the tax is reduced by at least 5 percent. The reduction takes place in 2 equal stages in 1971 and 1972.

Total tax change	1970	1979	1970	1979
Reform and relief	+4,615	+8,105	−2,167	−10,523
Surcharge	+3,100	....	....	....
Excises	+1,170	....	....	....
Total	+8,885	+8,105	−2,167	−10,523

The CHAIRMAN. We will see that that is done for you, Senator. All right, Mr. Evans.

STATEMENT OF T. M. EVANS, CHAIRMAN, CRANE CO.

Mr. EVANS. Mr. Chairman, I am Thomas M. Evans, chairman of the Crane Co. and the H. K. Porter Co., and I also operate a horse breeding farm, Buckland Farm in Gainesville, Va.

It seems to me there are a number of serious faults in the House approve tax bill, but there are three important points that I would like to discuss briefly.

1. Proposed changes in real estate. Money is tight now and I think we need every incentive to add new capital to the building industry because not only are we short of housing, apartments, factor buildings, et cetera, but also the cost of financing has gone up as well as the cost of building. Consequently, in my opinion, it would be harmful to change the depreciation regulations in such a drastic manner.

2. Proposed changes in donative sales. It seems to me to eliminate donative sales, that is, selling securities at cost and donating the difference, is removing an important source of income for small colleges and other worthwhile charitable organizations. In my opinion, putting a capital gains tax on the gift would not increase the Government revenue, but instead people just would not make the gift.

3. Proposed changes on limitations of deductions allowable to individuals in certain cases. The proposed legislation regarding the horse racing business is, in my opinion, completely unnecessary since the abuse is coming from the provision regarding recapture of depreciation. If the animal is depreciated as a business expense and later sold at a profit, the amount of depreciation taken should be recaptured at regular income tax rates, the same way that machinery sales are taxed to manufacturing business.

Apparently, when the law was written regarding animals used in business, this provision was overlooked and should be put into the law which would eliminate the abuse, and would not hurt legitimate people in the breeding and horse racing business.

Considering the revenue horse racing brings State governments, as well as the employment of unskilled labor that it provides, it would indeed be a mistake to pass this legislation that would practically eliminate any new people from going into the business.

Thank you for allowing me to come before your committee.

The CHAIRMAN. Thank you so much. We are happy to have you here today.

Now, the next witness is Mr. T. F. Dixon Wainwright of Philadelphia, Pa.

STATEMENT OF T. F. DIXON WAINWRIGHT, PHILADELPHIA, PA.

Mr. WAINWRIGHT. Mr. Chairman, and members of the committee, I am an attorney in Philadelphia and a tax practitioner and my comments are directed toward section 412 of the bill which has to do with the installment method of reporting gains. As to the merits of that section I have no comment but my comment concerns the effective date.

The bill provides that these amendments are effective as to all sales or other dispositions taking place after May 27, 1969, and I submit that

that is unfair to the taxpayers who have entered into binding contracts prior to that date.

As a tax practitioner I give advice to my clients in the best way I can, but the tax law, as Senator Moss said this morning, is extremely complicated. It takes a great deal of study so I may not always be right in my advice. But I certainly feel that my advice is nearly worthless if the law can be retroactively changed to affect it.

Thank you, sir.

The CHAIRMAN. Thank you very much, sir.

(T. F. Dixon Wainwright's prepared statement follows:)

STATEMENT OF T. F. DIXON WAINWRIGHT, ATTORNEY-AT-LAW, PHILADLEPHIA, PA.

(Re H.R. 13270, section 412(c) effective date of amendments regarding installment method of reporting gains)

SUMMARY

To the Senate Finance Committee:

The amendments apply to sales or other dispositions occurring after May 27, 1969.

In some instances this effective date will result in inequity and hardship to taxpayers who prior to May 28, 1969 in reliance upon the present law have executed contracts of sale which were binding upon them.

The amendments should not apply in cases where such contracts were entered into before the effective date.

DISCUSSION

Sec. 412 of H.R. 13270 would amend Sec. 453(b) of the Internal Revenue Code (relating to sales of realty and casual sales of personalty) by providing in effect (1) that an installment transaction is one in which the payment of the principal is spread relatively evenly over the installment period and (2) that certain evidences of indebtedness of a corporation shall not be treated as evidences of indebtedness of a purchaser.

As to whether or not the effects sought to be accomplished by these amendments are desirable or not I have no comment.

What would produce improper and inequitable results if it becomes law is Sec. 412(c) of the Bill which reads:

"Effective date.—The amendments made by this section shall apply to sales or other dispositions occurring after May 27, 1969."

There should be an exception for transactions where the contract or agreement of sale had been executed prior to May 28, 1969.

A seller should surely be entitled to rely on the law as to the installment method as it existed at the time that he bound himself by a contract of sale.

It is unfair for the law retroactively to change the tax effect of such a transaction. When a seller has bound himself by a contract prior to May 28, 1969, he cannot change its terms merely because the law changed afterwards. If at the time that he entered into the contract he had had any possible way of knowing that the provisions of H.R. 13270 might become law, he would have demanded a larger down payment from the buyer so that at the least he would have had funds in hand to pay the tax liability, which under the terms of this Bill would now all be bunched in the year of sale.

A typical situation affected by the amendments is a sale of real estate by an individual to a developer who makes a down payment at the time of the sale and gives a purchase money mortgage to secure payment of the balance of the consideration. Normally in such cases it is provided that the principal of the debt will become due in a relatively short period of time, say five or six years. Although there is no schedule for fixed part payments of principal prior to the due date, the mortgagor must pay part of the principal indebtedness from time to time in order to release portions of the land from the lien of the mortgage as the development proceeds. In such a case a landowner who contracted to sell in the proper belief that he had the right to report his gain on the installment method will suffer great financial hardship if the amendments retroactively take that right away from him.

As a tax practitioner I advise my clients to the best of my ability as to the tax consequences of various transactions that they wish to enter into. In order to do so I study the Internal Revenue Code, the Regulations, the cases and commentaries on the law. If I must also take into consideration possible future legislation retroactively effective, my advice would be a matter of guesswork and perhaps worthless. I submit that this is unfair to the taxpayers, because they are entitled to rely on reasonable certainty in the law. Specifically, prior to May 28, 1969 a taxpayer could not know that tax reform would include amendments to the Code with respect to the installment method of reporting and that such amendments would be retroactive.

Admittedly, it is not unusual for a change in income tax rates to be retroactively applied. Tax planning should always take into consideration the fact that there may be such changes. Such increases or decreases, however, are very different from a change in the *method* of taxation. If the latter type of change can be made retroactive, there can be no sound opinion or advice as to the tax consequence of any transaction.

Similarly, a tax practitioner may anticipate that the Internal Revenue Service will issue rulings in regard to the tax consequence of various transactions and that these rulings may be retroactive. Just this month such a ruling was issued in connection with the installment method. (Rev. Rul. 69–462, IRB 1969–35). Such rulings may be anticipated by a tax practitioner because they are *interpretations* of the present law and are not *changes* in it.

In other areas of tax reform H.R. 13270 provides exceptions to effective dates as to obligations binding upon taxpayers which were incurred prior to those dates. Such exceptions are found in Secs. 331 and 703 of the Bill which respectively concern deferred compensation and the termination of the investment credit.

CONCLUSION

It is accordingly respectfully submitted that the amendments proposed by Sec. 412 of H.R. 13270 should not apply to transactions where a bona fide contract of sale binding upon the taxpayer had been entered into prior to the effective date.

The CHAIRMAN. The next witness is Mr. S. Rayburn Watkins, president of the American Society of Association Executives, and Mr. George D. Webster.

STATEMENT OF S. RAYBURN WATKINS, PRESIDENT, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, WASHINGTON, D.C.; ACCOMPANIED BY GEORGE D. WEBSTER, WASHINGTON, D.C., COUNSEL

Mr. WATKINS. Thank you very much, Mr. Chairman.

The American Society of Association Executives consists of about 3,000 executives of various types of business and professional associations. You have the printed statement that we would like to have officially put into the record of this hearing.

I would like to comment briefly on three aspects of the bill. They are major to our membership but not major in context with the volume of the total bill.

The first one relates to the proposed taxing of advertising of association publications. It is our position that an association publication ordinarily relates to the tax-exempt purposes of the organization, and that if it does relate to them that the advertising revenue should not be taxable. If, on the other hand, the publication doesn't relate to such purposes, we don't think we have any ground to urge this committee not to tax such revenues.

The figures in our statement show that most of these publications are issued by relatively small organizations, that most of them actually do not produce a profit and, therefore, the total number of tax dollars involved isn't great. However, in the small association it sometimes is important to have this added thrust to its tax-exempt purpose.

The next aspect we would like to comment on is in connection with association-sponsored foundations, and we don't think there is much quarrel with the bill on this point. That perhaps through an oversight we are faced with a situation where an association that might make a contribution to its tax-exempt foundation would be considered a private contributor and, therefore, render some problems for it when, in fact, the association would be getting its money to make the contribution from a large number of its members. If a minor change could be made so that these contributions that really do in fact come from a variety of public sources wouldn't be considered as one contribution from the association and, therefore, render the entire foundation in jeopardy, we would like to submit this proposal for your consideration. We don't think the bill really intended it, but we do believe the way it is drafted it would put some of these foundations in jeopardy of being classified as "private foundations."

The third aspect concerns nonprofit organizations that have given up their tax-exempt status.

The way the bill is presently drafted they would not be permitted to carry forward or backward any losses that were sustained in their operation, and we think that it would be fair to permit that carrying forward and carrying backward if they are to be taxed on their income activities.

I am told that this particular section was drafted to treat such nonprofit organizations as gamblers, and we don't think that legitimate associations really fall in that category. We would like some protection on that.

The CHAIRMAN. Thank you very much, sir.

Senator CURTIS. I have one question.

The CHAIRMAN. Go ahead.

Senator CURTIS. Did you mean to imply that there was no objection to the House bill as it relates to foundations?

Mr. WATKINS. No; I didn't mean that. I merely said the aspect of it that concerns us, as the American Society of Association Executives, is that so many associations collect money from a large number of their members and then will make a lump sum contribution to the foundation. The language of the law as drafted would say that this is a private contribution and, therefore, would cause problems for the foundation. We do not comment on the private foundation aspects of the bill, other than this one comment.

The CHAIRMAN. I hope the staff would see to it that this matter is suggested in executive session.

Thank you very much.

Mr. WATKINS. Thank you.

(Mr. Watkins' prepared statement follows:)

Statement of Rayburn Watkins, President, American Society of Association Executives

SUMMARY

1. The American Society of Association Executives represents the interests of a great many business and professional associations.

2. Under the provisions of H.R. 13270, a number of the activities of our member organizations will be affected in ways which we feel are not consistent with the purposes of the bill and are not supported by policy considerations calling for the proposed legislation.

3. The bill should be changed to preclude the possibility that foundations which are supported by association members through contributions channelled through the association will not be classified as "private foundations" and thus become subject to the restrictions not consistent with the policing intent of the bill.

4. There are a substantial number of policy considerations against enacting the provisions of the bill which would tax advertising revenues of business and professional association journals.

5. The subsection heading of the advertising income provisions should be changed to prevent future litigation to determine the taxing limits of the section.

6. Proposed section 278 of the Code is not supported by any policy for equating legitimately operated organizations with gamblers insofar as their tax treatment is concerned.

STATEMENT

I appreciate this opportunity to appear before this Committee.

My name is S. Rayburn Watkins, and I am appearing on behalf of the American Society of Association Executives, Washington, D.C., of which I am President. This is a professional society, the members of which number over 2,900, each of whom is an executive in an industry or professional association. My organization thus represents almost three times as many industry and professional associations as any other group in the United States. We have members that are classified both under section 501(c)(6) and 501(c)(3) of the Internal Revenue Code, as well as under section 501(c)(4). I am accompanied by the General Counsel for ASAE, George D. Webster, a Washington, D.C. attorney, who also is counsel to many other industry and professional associations.

My testimony today shall be addressed to several provisions of H.R. 13270 which affect my organization and its members. These provisions relate to association-supported foundations, revenues received for advertising presentations in association journals, the over extension of the heading for subsection 513(c) of the Code, and the provisions limiting the deductions of nonexempt membership organizations.

Very often a membership organization will form a foundation for eleemosynary purposes. These foundations are funded by members contributions and are exempt from tax under section 501(c)(3). Frequently the smaller contributions of the members are paid to the member organization which in turn makes one large payment to the charitable organization it has formed.

Under the Act all section 501(c)(3) organizations are private foundations unless they fall within four prescribed exceptions. These exceptions are:

1. That class of organization which will qualify for the 30% charitable contribution limitation under the Act,
2. Organizations which meet the statutory test established to implement the concept of broadly supported organizations,
3. Organizations which exist to perform the functions, etc., of the above two classes of organizations or which are operated, supervised, or controlled by one of these types of organizations and which are not controlled by "disqualified persons" as defined by the Act, and
4. Organizations operating exclusively for testing for public safety purposes.

Under the Act it is possible that a foundation created by a member organization would fail to meet any of these exceptions. Exceptions 1, 3 and 4 would never apply simply by definition. The second exception would not apply where a number of members made contributions aggregating more than $5,000 to the membership organization for the express purpose of passing the funds on to the charitable organization. The membership organization would be considered a "disqualified person" when the funds were contributed to the charitable foundation and the charitable foundation would be a private foundation. Thus, an organization which receives support indirectly from a very broad base and which is not likely to be able to commit any of the culpable acts which the Act is intended to police becomes subject to restrictions which do not cure ills but rather frustrate charitable activities.

It is respectfully submitted that this result could be avoided by the simple addition of language to the support tests found in proposed section 509(a)(2) indicating that the test is to be applied on a *direct or an indirect basis.*

For some time the Internal Revenue Service has attempted to advance an argument that advertising fees for presentations in association journals constitute income which is subject to income tax because it is unrelated to the exempt functions of the organization publishing the periodical. This argument was never successful until the House passed section 121(c) of the Tax Reform Act amending section 513(c) of the Code. This provision accepts the premise that the sale of advertising space in a magazine can be fragmented from the publication of the magazine. The advertising then becomes subject to the tax even though it cannot, without resort to this new fiction, be divorced from the publication of a magazine which is confessedly in furtherance of the exempt functions of the published. I submit that the underlying policy considerations will not support the legislation in point.

A magazine or journal is a unit composed of both the editorial and advertising activities. When these two elements are fragmented by a ficition it then becomes necessary to test each element in terms of its affect on the exempt function of the publishing organization. This means each advertisement must be scrutinized to determine its relationship. To draw the line on an individual basis of advertising and to say that this is advertising which is unrelated and that advertising is related is to open the door to subjective judgment and would present to the IRS and taxpayers generally, an almost insurmountable audit problem and would only breed litigation since in effect each piece of advertising would be another case, i.e., as to whether the advertising was related to the exempt functions of the organization.

Accordingly, the proper measure of the unrelated business tax as applied to the advertising revenues of association publications, should be whether or not the magazine itself is related to the exempt functions of the organization involved, and if it is related in the main to the exempt functions, then no part of its net revenues should be taxed.

It should be further emphasized to this committee that I am advised by my membership that in general there is little net revenue involved in this area. A summary of our membership of over 2,000 industry and professional association executives indicates the following:

1. Approximately 20% have paid advertising in the association publication.
2. 11% of the overall budget of the association is from advertising.
3. The average gross income of the typical magazine selling advertising by the association is $50,000.
4. 60% of the 20% have a loss operation after a proper allocation of expenses.

Any tax which is imposed on the operation of an association journal is an increase in the cost of membership, and thus it is a tax on small association members for acting collectively to advance the interests which each could advance acting alone only at much greater expense. In the main our membership is not composed of the large industry and professional associations but is composed of smaller groups. Of our 2,900 members, over half of the membership involved are associations which have budgets of less than $100,000 per year.

These publications take the form of weekly newspapers and magazines which are generally the spokesmen for the industry as well as also being the educational catalysts for the industry. The magazine and publications of my members are devoted exclusively to reporting news of real importance and general significance to the membership of the particular organization involved. In the case of magazines run by the associations, their chief interest is to carry out the exempt purposes of the particular organization involved. These magazines are not competitive with any other publication because there can be no commercial equivalent to the particular magazines or publications involved. The commercial magazines have an entirely different point of view in that they are operated for profit. Our magazines and publications are operated primarily to seve the exempt purposes of the particular operation involved. Most, if not all, of the publications of my members are made available to the membership and in some cases to some of the non-members. These publications are not available on the newsstand and are not generally available to the public. In many cases, they are "house organs."

To say that these magazines compete in the market place for advertising is a misrepresentation. The answer is that the publications of my members are in a peculiar position of serving the best interest of the industry and in a substantial number of cases the magazines of my members are operated at a loss. They are not operated for a profit as are commercial publications; they are operated to serve the membership of the association involved. If it were not for the association, in the vast majority of cases, it is my opinion that the magazine would not even exist since a commercial publisher would not be in a position to underwrite the loss that would necessarily result.

Many of the educational functions that are performed by associations are paid for in whole or in part in some instances by advertising revenues. This is a subsidy. If this subsidy is denied as it would be if the advertising revenues are taxed, the result could be that many functions performed by private educational organizations would have to be performed by the government, if they are performed at all. The long term result of taxing advertising revenues might well be increased costs rather than increased revenues, for the government.

It is respectfully requested that this Committee refuse to endorse the provisions of section 121(c) of the Act.

Further injustice can be seen in the subsection heading to the proposed sunbsection 513(c) as found in section 121(c) of the Act. The section is headed "Advertising, etc., Activities." It is submitted that in the event Congress decides to tax advertising in trade journals this mandate should be expressed in terms which will not lead to future litigation to determine what "etc., Activities" are.

Some of the members of our organization were originally exempt from tax under section 501(c)(6) of the Code. These members are no longer exempt under that section; however, they do remain nonprofit organizations which seek to advance the common business interests of their members in a collective fashion. Section 121(b)(3) of the Act would create section 278 of the Code: a section limiting the allowable deductions for services to members to the amount of income derived from members. Because of the annual tax accounting concept on which one system is based this woulld mean that a loss in one year from this kind of operation would not be deductible against the very same kind of income in the next year. This section has the effect of equating legitimately operated organizations with gamblers insofar as their tax treatment is concerned. There is no policy to support such treatment, and the section should be deleted or amended to allow carry-over and carry-back of losses.

The CHAIRMAN. Now, the next witness will be Mr. Leon O. Stock.

STATEMENT OF LEON O. STOCK, MEMBER, PEAT, MARWICK, MITCHELL & CO.

Mr. STOCK. Mr. Chairman, I appear here today on behalf of several corporate clients. In listing Crown Textile I made a mistake. I had originally intended testifying on some other subject.

My name is Leon O. Stock. I am a member of the international accounting firm of Peat, Marwick, Mitchell & Co. I appear here on behalf of several corporate clients, Sterling Stores, United Dollar Stores, Diana Stores, Rockower Bros., and Genesco, Inc. I am opposed to the elimination of the multiple surtax exemption as proposed by the House and by the Treasury.

As you may recall, the House bill proposes the elimination over an 8-year period. The Treasury would eliminate the exemptions over a 5-year period. Last March I appeared before the House Committee on Ways and Means and at that point cited as an illustration the unfairness in given circumstances of the elimination. I cited the case of a chain of retail stores operating in small outlying communities, one particular store operating in a small town in Pennsylvania called Honesdale, on the main street. Four doors away, a one-store corporation operated in competition with the chain store, both stores presumably earned less than $25,000 a year after tax. If the one-store corporation is to be subjected to a tax of 22 percent, and the chain store corporation operating four doors away is to be subjected to a tax of 48 percent, then necessarily there must be resulting competitive disparity between the two.

I now have additional facts on nine other chains. One chain which should be unidentified for competitive reasons shows the following salient facts. It consists of 110 retail stores in the outlying communities. It has total sales overall of $14 million. Its net income after tax is $879,000, thereby indicating a ratio of after tax profit to sales of 4.8 percent. Its net average income per store is approximately $6,100. It employs 230 people.

With an individual store in an outlying community earning approximately $6,100, and 40 stores actually suffering losses, there appears to be little competitive margin for increased tax costs. A chain, we all know, is just about as strong as the links that go to make it up, and it would be, in my judgment, a horrible mistake to look at this chain and conclude, that because it has earned $679,000 as overall profit, this chain can stand additional tax costs. One sensible way to evaluate the tolerance of this chain to the additional tax is to look at the profit per unit and the competitive position of each unit.

Now, we have nine other chains where the average profits run below $10,000 per store. There isn't much fat on the carcass, and there are two questions which I think this committee ought to ask itself: First, can these chains operating in outlying communities and earning less than $10,000 per store absorb any additional tax costs without being compelled to re-examine their position in these communities with possible curtailment or elimination of some of the stores thus leaving the consumer then with an increasing price level.

Gentlemen, after much consideration and much discussion with clients, we would like to submit for your consideration some alternative proposals. One, perhaps a moratorium period of 3 years during which no change would be made, followed by the proposal to phase out the multiple surtax exemptions over the next 7 years. Alternatively, a moratorium period for 5 years, with a subsequent phaseout over the succeeding 5 years; and finally, as an alternative, a straight phaseout over 10 years.

Thank you.

The CHAIRMAN. Thank you very much.

Senator CURTIS. I would like to ask something for the record and you can supply it to our staff. I would like to know what the present law is in regard to multiple surtax exemptions, what situations qualify for it, the extent to which it is the same ownership of various smaller corporations, and then I would like to know what the House bill proposes and what change the Treasury proposes.

If you would supply that so that we could have a concise definition of what we are talking about.

Mr. STOCK. I might add, in parting, Senator, that it is significant that the large super grocery chains do not claim the multiple surtax exemption. They either operate through unincorporated divisions or if they do have subsidiaries they file consolidated returns which means only one surtax exemption.

The reason your big companies, J. C. Penny, all of your supermarket chains, do not claim the multiple surtax exemption is because they aren't confronted with any one-man competition, they don't operate a specialty shop on main street in one small town operating against the one-store operators or the franchise operators. They are in competition to some extent with the big chains but none of these chains claim the multiple surtax exemption because they are not up against the little man. I submit very respectfully that discrimination is bad no matter in which direction it is aimed at. Chains operating small units must be given some tax relief.

The CHAIRMAN. What I want are the facts as to how they operate.

Mr. STOCK. Thank you.

The CHAIRMAN. Thank you very much.

(The witness failed to supply the information requested. Leon O. Stock's prepared statement follows:)

STATEMENT OF LEON O. STOCK, MEMBER, PEAT, MARWICK, MITCHELL & CO.

SUMMARY

A. Allowance of multiple surtax exemption justifiable in appropriate circumstances and accordingly should not be indiscriminately or prematurely terminated.

I. Chain store corporations, particularly in smaller communities would be placed at a competitive disadvantage vis a vis. one store corporations and franchised store corporations if tax burden on former is increased through elimination of multiple surtax exemptions. Tax neutrality required if competitive parity is to be maintained.

II. Chain store corporations in smaller communities realized relatively small earnings after tax, leaving little, if any, margin for an increase in tax cost.

III. Inadequacy of after-tax profit may induce chain store corporations to close down, rather than expand, resulting in a likely increase in consumer prices.

B. Suggested legislation for Committee's consideration—please refer to Paragraph X of Statement following this Summary.

STATEMENT

I. This statement submitted by Leon O. Stock, a principal in the international accounting firm of Peat, Marwick, Mitchell & Co., is in opposition to the specific proposal passed by the House to phase out multiple surtax exemptions in the case of controlled corporate groups as defined.

II. On March 24, 1969, the writer appeared as a witness before the House Committee on Ways and Means and expressed the view that the allowance of more than one corporate surtax exemption, in appropriate circumstances, was and continues to be justifiable and, accordingly, should not be indiscriminately eliminated.

The writer then by way of illustration made reference to the case of a retail chain principally in the sale of undergarments in small outlying communities, for example, a store on Main Street in the small town of Honesdale, Pennsylvania, where it is and has been for a long time in competition with a one-store operator several doors away.

III. In the Honesdale illustration, the assumption was made that the competing stores each earned less than $25,000, and that each paid a corporate tax of 22 per cent (plus an additional tax of 6 percent in the case of the chain-store corporation). The conclusion was then expressed that the prevailing substantial tax equality between the two stores would cease to exist if the chain store corporation were required to pay a tax of 48 percent and the one-store corporation a tax of only 22 percent.

IV. Since testifying before the House Committee the writer has been supplied with facts and figures relating to chainstore operations in small outlying communities. Let us consider one such a chain in relation to its last fiscal year which for competitive reasons will remain unidentified:

(a) Number of Stores, 110.
(b) Sales Volume, $14,000,000.
(c) Net income after tax, $679,000.
(d) Ratio of (c) to (b), 4.8%.
(e) Average net income per store, $6,172.
(f) Number of loss stores, 40.
(g) Number of employees, 230.

V. The above-referred to chain consisting of retail specialty stores employing modern methods of distribution brings to the small communites consumer-acceptable products at reasonable prices. Its individual store profits are modest, leaving little competitive margin for increased tax costs.

The types of products and goods sold by chains in the small communities at the retail level include jewelry, woman's wear, undergarments and hardware.

VI. The writer has also been supplied with data on several other retail specialty chains. One such chain, wth sales of $11,619,000 from 87 stores had an average net ncome pér store of only $3,552 after taxes. Of the 87 stores in that chain, 20 stores operated at a loss, and an additional 47 stores had income of less than $10,000 per annum. Only one store in the chain had income of $25,000 or more.

In the 9 chains, in respect of which data has been obtained, the number of individual stores ranged from 32 to 456. Only one chain, and that was the smallest, had more than 50 percent of the stores operating with profits of over $10,000. One chain had more than 93 percent of its stores making less than $10,000, and four chains had more than 72 percent of the stores in each chain making less than $10,000. Percentages of stores with less than $10,000 in profit for the other three chains were 61 percent, 66 percent and 67 percent respectively.

While net income after taxes ranged from $90,000 to $2,023,782 for a total of all stores, the average net from each store ranged from $1,500 to $24,800. The stores in the smallest chain (32 stores) had the highest average net income. The stores in the largest chain (456 stores) had average net income of $4,000 and 119 out of the 456 stores operated at a loss. It is respectfully submitted that looking at the overall results of the chain, rather than individual units in the chain, gives a misleading impression.

VII. Chain store vendors in the small outlying communities are engaged in competition at the grass roots. Taxes, constituting a cost of doing business, may easily become self-defeating insofar as the public revenue is concerned if:

(a) The adequacy of the after-tax income becomes doubtful in the opinion of management and continuation of the business consequently becomes economically questionable.

(b) The chain store is placed at a competitive disadvantage, tax-wise, thereby dictating possibly a termination of the local business in favor of the one-store operator.

VIII. Needless to say, the determination to furnish services, products and goods is dependent on the bottom-line profit and loss figures, i.e., after-tax earnings. Any tax or other economic factor that denies operational adequacy of return can only cause a curtailment or termination of the effected business. This, in turn, could unfavorably effect the consumer principally in one of two respects:

(a) If a corporate store unit in a chain is closed, a competitor in that area may be encouraged to increase his prices because of the lack of competition. In the ghetto communities, prices are sometimes inflated partly because of the absence of responsible competition. Furthermore, an increase in the tax burden would likely lessen the incentive to expand through the establishment of new retail outlets. Again a negative factor leading to possible price increases.

(b) If the closed corporate store unit is located in a smaller community, it may leave the residents of such community, at least temporarily, without any retail medium through which they can satisfy their needs for consumer products or goods.

IX. Accordingly, before any action is taken to eliminate or phase out the multiple surtax exemptions, particularly in the case of the chain stores operating in the small outlying communities, two critical questions should be considered:

(a) Is there enough fat on the carcass to absorb a tax increase such as would result from elimination of the multiple surtax exemptions?

(b) Would the chain store corporation be placed at a competitive disadvantage in relation to the one-store corporation and the franchised store corporation, if the multiple surtax exemptions were eliminated?

The chain store, it would appear clear, would suffer on both counts.

X. Another factor to consider is that chain store corporations may be "locked in" until expiration of their leases. For this reason, as well as others heretofore considered such as the resulting competitive disadvantage of the chain store vis a vis, the one store corporation and the franchised store corporation, the following suggestions are submitted for consideration by the Committee:

(a) Provide a moratorium period of 3 years commencing with taxable years beginning after December 31, 1969, during which no statutory changes would be made in the allowance of multiple surtax exemptions.

(b) Provide the commencement of a phase out period of 8 years, following expiration of the moratorium period of 3 years, during which the multiple surtax exemptions would be scaled down to the point of elimination as provided in the House Bill.

(c) Alternatively, providing a moratorium period of five years to be following by a phasing out period of 5 years, or simply a straight 10 year phase ou tof the multiple surtax exemptions.

(d) Increase in equal annual amounts the dividends received deduction from 85 percent to 100 percent over the phase out period of 8 years.

(e) Permit without the filing of a consolidated return, the operating loss of a member of the controlled group to be allocated to, and deducted by, other members of the group, limited, however, to the same percentage of such loss as the disallowed percentage of the multiple surtax exemptions for the year in which the loss was sustained. Also permit such losses to be deducted in a consolidated return as provided in the House Bill.

XI. The moratorium and phasing out periods would enable the chain store to meet its business commitments in an orderly manner and make whatever adjustments in its operations it may consider necessary or desirable. The annual increase in the dividends received deduction, and the allocation of operating losses from one member to the other members of the group, would compensate appropriately for the gradual denial of the surtax exemptions.

The CHAIRMAN. Well, that concludes this morning's hearings unless some Senator wishes to call back one of these witnesses for further interrogation.

Thank you very much.

We will meet at 9:30 tomorrow morning, we have a longer list of witnesses.

(There follows, written testimony received by the committee expressing an interest in the various aspects of the bill relating to corporations:)

SOUTHERN NATURAL GAS CO.,
Birmingham, Ala., September 10, 1969.

Re Alternative capital gain rate for corporations, section 461—H.R. 13270.

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

DEAR SIR: Section 461 of H.R. 13270 will increase the alternative capital gains tax on corporations from 25% to 30%. We are opposed to this section because it erroneously assumes that the laws applicable to capital gains of corporations and individuals are comparable, erroneously assumes that corporate capital gains are more in the nature of business income than investment income, and erroneously adjusts the capital gains tax of corporations as an adjustment comparable to the proposed adjustment in individual capital gains tax rates. Its enactment will remove corporate funds which might be used for investment capital and will constitute a permanent surcharge on corporations.

Ever since the passage of the Revenue Act of 1921, it has been accepted that the sale of a capital asset yields a significantly different type of income from that subject to normal income tax rates. However, that which constitutes a capital gain is distinctly defined and is limited to certain definite transactions under existing revenue laws.

Furthermore, the tax treatments of capital gains and losses for corporations and individuals are undeniably different under existing laws. Whereas an individual is, under Section 1202 of the Code, given the benefit of a statutory deduction, generally equal to fifty percent of net long term capital gains in excess of net short term capital losses, no such deduction is available to a corporation. Permission to deduct net capital losses against ordinary income, to any extent, is reserved to individual taxpayers and a corporation may only use such excess loss as a capital loss carryover to be offset against future capital gains, if any. Even in the related area of capital loss carryover the period of availability is limited to five years to corporations even through such privilege period is unlimited as to individuals. In view of these distinctly different tax treatments of the capital gains and losses of corporate as compared to individual taxpayers, we oppose any increase in the alternative capital gain rates for corportions as proposed in H.R. 13270. The proponents of such increase erroneously conclude that the laws applicable to capital gains of corporations and individuals are comparable (Committee Print p. 75). Since this is not true, as we point out herein, the increase provided for corporations should not be promulgated.

The proposed increase in alternative capital gain rates is based on the premise that corporate capital gains, in comparison with those of an individual, are more in the nature of business income not essentially different from other business income. Such premise completely ignores the existence and effect of Section 1221 and other related sections of the Code wherein capital assets are defined. There should be no prevailing doubt that a taxpayer, whether corporate or individual, engaging in the frequent and continuous buying and selling of what would normally be investment property will be denied capital gains treatment on such transactions under already existing revenue laws and court decisions.

The proposed increase in capital gain rates being based on the grounds that corporate activity produces something more in the nature of business income rests also on the premise that a corporation, as an artificial entity, cannot hold any property for investment as is the privilege of the real individual. This distinction is not well taken since it ignores completely the economic facts of life.

An analysis of effective tax rates applicable to individuals and to corporations indicates that the proposed corporate alternative tax rate of 30% is comparable to an individual tax rate of 60%, considering the statutory 50% deduction available to the individual. Such a comparison is based on a tax bracket which approaches the maximum since the indivdual maximum effective tax bracket as applied to long term capital gains utilmately will be 32½%. Such an analysis approximating maximum taxation on a comparable individual basis does not appear to be reasonable or statistically founded.

We also oppose the ncreasing of the corporate alternative tax rates as a comparative raise in the individual taxation of capital gains since such an increase is arbitrary, discriminatory and, in effect, constitutes a *permanent* surcharge on corporations which have gains from the sale of investments held over an extended period of time, usually at a substantial risk. We also point out that the enactment of Section 461 will result in the redistribution of income from the corporate sector—where it might be used for investment—to the individual sector—where it might be used to purchase consumer goods—with adverse effect on our economy.

Respectfully submitted,

SOUTHERN NATURAL GAS CO.,
PETER G. SMITH,
Vice President, General Counsel and Secretary.

STATEMENT BY MICHAEL WARIS, JR.,[1] AND PETER L. BRIGER[2]

SUMMARY

I. *Finance Committee Previously Rejected Identical Proposal*

After very thorough study Congress in 1951 (spearheaded by the Senate Finance Committee) and 1964 rejected virtually the identical proposal presently being advanced by the Treasury to eliminate multiple surtax exemptions. Many taxpayers are required by the very nature of their businesses to operate through multiple corporations. Many businesses have been developed on reliance of the existing rules—particularly in view of past Congressional actions. The law presently contains sufficient measures to eliminate tax abuse and avoidance

[1] Baker & McKenzie, Washington, D.C.
[2] Baker & McKenzie, New York, N.Y.

through multiple corporations. None of the basic facts has changed since Congress last considered the issue. Has Congress been wrong all these years? There is no real justification for changing the law now—and it would be inequitable to do so.

II. *Other Code Provisions Being Disregarded*

The Treasury's basic premise in calling for the termination of the multiple surtax extension (namely, that from an economic standpoint an affiliated group of corporations electing the exemption is a single business unit) is erroneous and misleading. It disregards and is in direct conflict with a number of key provisions of the Internal Revenue Code requiring that related or controlled business entities must be treated as though they were separate and wholly unrelated businesses dealing at arm's length. Moreover, net losses of one member of a group cannot be used to offset the profits of other members. Dividends (which may include intercompany loans) are subject to an effective tax rate of 7.9 percent. The net effect of the Treasury's position is to deprive that class of taxpayers required by their business to use multiple corporations of the only significant tax benefit available to them, while leaving them saddled with numerous detriments due to their need to use separate corporations.

III. *Consolidated Return Regulations Will be Rendered Unconstitutional*

Elimination of the multiple surtax exemption could render the consolidated return provisions unconstitutional to that class of taxpayers required by the nature of their business to operate through a number of corporations. The reason is that such taxpayers will not be left with any real choice of whether or not to file consolidated returns. As was clearly recognized by the Senate in 1928, because of the legislative function delegated by Congress to the Treasury in this area, the existence of a meaningful election on the part of taxpayers as whether or not to become subject to the consolidated return provisions is essential to assure their constitutionality. The Treasury's regulations in this area depart substantially in a number of respects from the basic tax rules provided by Congress in the Internal Revenue Code and in several situations provide treatment for affiliated groups that is substantially more adverse than is the treatment under the Internal Revenue Code for unitary corporate taxpayers operating through branches or divisions.

IV. *Equity Requires More Liberal Transitional Rules—Solution to Constitutional Problem Suggested*

If the multiple surtax exemption is eliminated, a more liberal transitional phase-out period should be permitted to minimize the disruptive financial impact upon those taxpayers which relied upon Congress' prior action in this area. Reorganization expenses incurred by taxpayers in simplifying their corporate structures should be allowed as deductions during this period. The phase-out period should not be commenced until the question concerning the constitutionality of the consolidated return regulations is resolved. This could be accomplished promptly if Congress were to delegate to the Treasury the function of initially drafting the regulations but were to retain for itself the responsibility of actually promulgating the final provisions. It is submitted that a phase-out of the multiple surtax exemption proportionately over 20 years, 5 percent per year, would be an appropriate transitional period.

Statement Before Senate Finance Committee

PROPOSED ELIMINATION OF MULTIPLE CORPORATE SURTAX EXEMPTIONS

(By Michael Waris, Jr. and Peter L. Briger)

I. *Surtax Exemptions Have Repeatedly Gained Congressional Approval After Careful Study—The Same Treatment Is Presently Warranted*

For almost two decades—indeed since the outset of the present system of subjecting corporations to a normal tax and a surtax, the tax statutes of the United States have respected the separate existence of each corporate entity formed and operated for good business reasons. Conversely, corporations formed merely to gain tax advantages have been denied such separate identity for surtax exemption purposes. Now, in the name of tax reform, the House of Representatives has endorsed a Treasury proposal which would jettison this fundamental precept.

More is at stake in this move than the immediate issue of corporate surtax exemptions. Involved here is the far-reaching process of ignoring for an immediate revenue objective a basic legal concept which provides a rational framework on which business affairs can be planned, organized and operated, i.e., the full integrity of the separate existence of each viable corporate entity.

The consequences of taking these extreme steps should be carefully weighed before they are adopted. Aside from the immediate inequities which are discussed below, the disadvantages to the tax structure as a whole should be taken into account. Each time an arbitrary tax rule ignoring legal and factual realities is adopted, experience has shown that other abritrary rules inevitably follow in order to make the artificial creation function. The result is an ever more complex, unwieldy and unworkable Internal Revenue Code.

It is most important to keep in mind that on two prior occasions the Congress has considered this very same issue of eliminating multiple surtax exemptions—once in 1951 and again in 1964. Each time—after thorough study—and based on exactly the same facts and considerations as exist today—Congress refused to accept the same across-the-board abandonment of the separate entity concept which the Treasury for the third time is urging upon it.

Also of great significance is the fact that in the past the Senate has played the leading role in preserving the integrity of the corporate entity—in 1951 reversing the action of the House. Thus, there is a striking revisitation of history in the present posture of this issue—with the Senate again being called upon to preserve a long-standing logical arrangement. Accordingly, to put the matter into clear perspective it will be helpful to examine in more detail the reasons for the prior Congressional action to see whether Congress erred on those two prior occasions—or whether the error lies on the part of those who would effect a change at this time.

A. CONGRESSIONAL ACTION IN 1951

In 1951, without any hearings on the issue, the House of Representatives passed a provision essentially similar to the one in the present House bill eliminating multiple surtax exemptions. The reasons given for the House action have a familiar ring, the report of the Ways and Means Committee stating that to give each member of a group of related corporations a separate surtax exemption "confers an unwarranted tax advantage on business carried out by means of a series of corporations, rather than a single corporation, and sets up an incentive for the artificial splitting up of corporations. This effect of the existing law is difficult to reconcile with the fact that the surtax exemption . . . [was] intended to confer tax advantages on small business." [3]

The 1951 report of the Ways and Means Committee goes on to sound an urgent note also having a very familiar ring currently (so much so that it is difficult to believe that almost twenty years have intervened):

> While these amendments to the surtax exemption . . . would be desirable in any event, they are particularly necessary at the present time. The substantial revenue loss under existing law is difficult to reconcile with the current budgetary stringency, and this revenue loss might be increased by the deliberate splitting up of corporations for the purpose of realizing the unusual tax advantages which present law permits in a period of high corporate tax rates.[4]

Extensive hearings were conducted by the Senate Finance Committee in 1951 and a large number of witnesses testified with regard to the House provision. As a result the House action was rejected. The reasoning of the Senate Finance Committee is clear and concise. It is as convincing and valid today as it was in 1951.

The Finance Committee's basic reason for rejecting the House proposal was that the amendment was so "broad in its attack that, if enacted, it could result in substantial injury to many businesses whose present corporate structure has not been motivated by tax avoidance." [5] After pointing out a number of reasons commonly dictating the use of separate and multiple incorporations as a means of doing business the Committee stated:

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[3] H.R. Rep. No. 586, 88th Cong., 1st Sess., 1951–52 C.B. 374.
[4] Ibid.
[5] S. Rep. No. 781, 82d Cong., 1st Sess., 1951–2 C.B. 506, 507.

All of these are traditional and legitimate purposes for the creation of new and separate corporations, *yet the House bill would strike these bona fide corporate entities in the same manner as it would treat cases of true tax avoidance.* (Emphasis added.)

The Finance Committee also noted that, although opportunities for tax avoidance might exist through the use of multiple corporations, the predecessors of sections 482 and 269 afforded the Treasury adequate protection in cases where tax avoidance was the principal purpose of utilizing multiple corporations. The Committee concluded that any further study undertaken to develop methods of limiting avoidance in this area "should emphasize the importance of correcting the true cases of avoidance without working a hardship on legitimate business organizations."

In Conference, the House concurred in the action taken by the Senate and offered as an amendment the predecessor of section 1551 of the Code, which is designed to prevent the artificial split-up of existing businesses for the purpose of obtaining additional corporate surtax and excess profit exemptions. This provision was enacted into law as part of the Revenue Act of 1951 and has remained an effective barrier against the artificial creation of multiple surtax exemptions.

CONGRESSIONAL ACTION 1963 AND 1964

Early in 1963 the Treasury Department again proposed the elimination of multiple surtax exemptions for precisely the same reasons as in 1951. In addition the Treasury submitted to the Congress voluminous materials describing in detail the tax savings inherent in the multiple corporate structure. Thus, the Congress was fully informed as to the applicable arguments and the extent of tax savings available to multiple corporate structures by reason of surtax exemptions.

However, as it had done in 1951, the Congress again refused to adopt the Treasury's proposals to eliminate multiple surtax exemptions. Again its reasoning was precise and forceful. The House Ways and Means Committee, now fully in accord with the 1951 thinking of the Senate Finance Committee, stated:

> While your committee recognizes the advantages of use of multiple corporations, your committee believes, as it has in the past, that, where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type of business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions.[6]

From the foregoing, it is apparent that in very recent years Congress has carefully studied and analyzed the desirability of permitting each member of an affiliated group of corporations to file a separate return and claim a separate surtax exemption. On the basis of its repeated and exhaustive consideration of the matter, Congress has twice determined not to eliminate the right to elect multiple surtax exemptions. It has concluded that the proper route to follow in order to avoid abuse of the exemption is carefully to police the area, utilizing the several statutory provisions already available.

The basic facts and conditions relating to utilization of multiple surtax exemptions and the filing of separate returns have not changed to any significant degree since 1964. The Treasury's own statistics do not show that there has been any material increase in the number of affiliated groups of companies electing to claim multiple surtax exemptions. Under all the circumstances, there would appear to be no bona fide reason for Congress to change the ground rules in this area.

One observation regarding the inequity involved in changing the law under such circumstances seems warranted. As was clearly recognized by both the Treasury and Congress, there are certain groups of taxpayers, particularly those in the retail apparel business, the restaurant and quick food service business, and the consumer finance or small loan business, who are forced by the very nature of their businesses to utilize multiple corporate forms of organization. While no taxpayer or group of taxpayers has a vested right in any of the provisions of the Internal Revenue Code, these groups or classes of taxpayers have relied, and it is submitted they acted reasonably in doing so, upon the above-described action of Congress in planning their corporate affairs and in arranging

[6] H.R. Rep. No. 749, 88th Cong., 1st Sess., 1964–1 (Part 2) C.B. 242.

their structure for conducting business. It therefore is extremely inequitable for Congress at this time to reverse the position that it has taken in both 1951 and 1964, particularly since none of the underlying facts or considerations have changed in any material degree.

II

Treasury's case is based on erroneous premise: Its position that an affiliated group of corporations is a single business enterprise is in direct conflict with a number of code provisions treating each member of the group as a separate entity

The basic premise underlying the Treasury's contention that the election of multiple surtax exemptions by an affiliated group of corporations is a tax loophole is that such group of corporations is, for tax purposes, conceptually nothing more than a single business entity.[7] While superficially this argument seems to be valid from an economic standpoint, it disregards and is in direct conflict with a number of key provisions of the Internal Revenue Code.

In recent years one of the provisions of the Code most actively administered by the Treasury Department has been section 482. The heart of that provision is the principle that all related or controlled business entities, in their intercompany dealings, must be treated or regarded for Federal income tax purposes as though they were separate and wholly-unrelated businesses dealing at arm's length.

The net operating loss is another item which causes the Treasury to have double vision rather than the singleness of view it manifests where the multiple surtax exemption is involved. Thus, if one member of an affiliated group which elects the multiple surtax exemption incurs a net operating loss, such loss cannot be used to offset the profits of any other member of the group. Each company is required to stand on its own and is treated as a separate business.

Similarly, if one member of an affiliated group electing multiple surtax exemptions lends money to another member of the group, the Treasury is quite likely to maintain that the intercompany loan is a constructive dividend to the common parent of the group Fifteen percent of the dividend deemed to have been received in such situations is subject to corporate taxation.[8]

As a result of the various adverse tax consequences which accrue to affiliated or controlled groups of corporations electing multiple surtax exemptions when they do not treat each other as if they were separate business entities dealing on an arm's length basis, the Treasury undoubtedly derives a substantial amount of revenue that it would not otherwise receive if the affiliated group could operate as a single corporation or filed a consolidated return. It would be significant to learn from the Treasury the total amount of income tax deficiencies arising in 1968 by reason of constructive dividends. The Treasury has estimated that approximately $235,000,000 of tax revenues was lost in 1968 as a result of the multiple surtax exemption. This statement is misleading. To be truly meaningful this figure should be reduced to reflect the tax collected on intercorporate dividends, the inability of one member of an affiliated group to utilize the net operating losses of other members, and the taxes currently paid on profits generated upon intercompany transactions. Quite possible there may be no loss of tax revenues due to the use of multiple corporations, but, in fact, a net gain in tax collections.

The net effect of the Treasury's position is to deprive related corporations of one of the few significant tax benefits now available to them as separate entities while leaving them saddled with numerous tax detriments flowing from their separate incorporation. The Senate should reject this conceptually inequitable approach.

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[7] See footnote 7 at p. 243 of the Tax Reform Studies and Proposals of the U.S. Treasury Department issued as a joint publication of the Committee on Ways and Means and the Senate Finance Committee dated Feb. 5, 1969.

[8] Indeed, the predecessor of section 243(a)(1) (which makes some portion of intercorporate dividends subject to full rates of tax) was enacted by Congress specifically to prevent the use of multiple corporations to avoid taxes. Thus, in 1935, Congress reduced to 85 percent the 100 percent intercorporate dividend received deduction, which was designed to eliminate double or multiple taxation of the same income at the corporate level. The deduction was reduced from 100 to 85 percent to prevent the possibility of evasion of taxes under then existing law (which instead of using a surtax exemption, taxed corporations on a graduated basis). It was believed that one possible means of evading the effective graduated tax rate was through the division of existing businesses among numerous subsidiaries or affiliates. H. Rept. No. 1681, 74th Cong., 1st Sess. 1939-1 C.B. (Part 2) 643, 647; S. Rept. No. 1240, 74th Cong., 1st Sess. 1939-1 C.B. (Part 2) 651, 654. This is another clear example of the fact that existing law already contains specifically enacted deterrents to the splitting up of businesses among multiple entities and provides certain carefully considered adverse tax consequences in connection therewith.

Effect of elimination of multiple surtax election will be to force taxpayers requiring multiple corporate structure as a matter of economic necessity to file consolidated returns

If Congress decides to eliminate the multiple surtax election, the direct and necessary consequence of such action will be to force the majority of those taxpayers whose businesses require them to operate in multiple corporate form to file consolidated returns under sections 1501 through 1504 and the underlying Treasury Regulations. In other words, such taxpayers will not be left with any realistic choice of whether or not to elect to file consolidated returns. The elimination of the multiple surtax exemption (and the other ancillary benefits resulting from separate corporate status) will necessarily and effectively determine their course of action. Probably in the majority of cases, the nature of their businesses prevents them from operating through branches or divisions of a single corporation. They are required to utilize a number of corporations through which to conduct their business activities. It seems unrealistic and unfair for the tax laws to provide that, as regards all of the adverse consequences (such as intercompany sales and the utilization of net operating losses), such entities must operate as separate taxpayers engaging in separate businesses, while as regards the surtax exemption to provide that such entities will be regarded as a single business enterprise.

In essence that class of taxpayers, required by the nature of their business to utilize a number of corporations, will have the worst of all possible worlds. Consequently, most taxpayers falling into this class will be compelled to file consolidated returns.[9]

If Congress eliminates the multiple surtax exemption, a serious question will arise concerning the constitutionality of the consolidated return provisions as applied to taxpayers whose business requires them to operate in multiple corporate structure. This question was clearly recognized by the Senate in 1928 when it specifically reviewed the legislative history of the consolidated return provisions and authorized the Treasury to prescribe regulations, legislative in character, concerning the filing of consolidated returns.

Initially, when Congress in 1918 authorized provisions for consolidated returns, it did so by conferring upon the Treasury explicit authority to require that such returns be filed on a mandatory basis. Consolidated returns were regarded by the Treasury as a means of preventing the avoidance or distortion of income as a result of intercompany transactions between affiliated or related taxpayers.

The House, in 1928, after considering the desirability of consolidated returns, eliminated or struck the authorization conferred upon the Treasury in this respect. The Senate Finance Committee, however, reinstated the consolidated return provisions. It noted that provisions for the filing of consolidated returns should be continued because the principle of taxing as a business unit what in reality is a business unit, is sound, equitable and convenient both to the taxpayer and the Government. However, it pointed out, that a number of difficult and complicated problems had arisen in the administration of these provisions and that it was impracticable to attempt by legislation to prescribe the various detailed and complex rules necessary. The Senate Finance Committee indicated that it:

> "* * * found it necessary to delegate power to the Commissioner to prescribe regulations legislative in character covering [the filing of consolidated returns]. The standard prescribed by the section keeps the delegation from being a delegation of pure legislative power, and is well within the rules established by the Supreme Court. (See *Hampton, Jr. & Co.* v. *United States*, decided by the Supreme Court on April 9, 1928, and the cases there cited.) Furthermore, the section requires that all the corporations joining in the filing of consolidated returns must consent to the regulations prescribed prior to the date on which the return is filed." S. Rept. No. 960, 70th Cong., 1st Sess., C.B. 1939–1 (Part 2) 409, 419.

This additional safeguard of requiring an election by the corporate members of an affiliated group constituted clear recognition by Congress that, in dealing

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[9] This result is clearly recognized by the House bill which includes a provision that losses sustained by a member of a controlled group of corporations prior to the filing of consolidated returns can, contrary to existing law, be taken as a deduction against the income of other members of the group in the same proportion as the additional surtax exemptions of the group. This particular provision is, in fact, an additional factor eliminating any effective or meaningful choice on the part of taxpayers with multiple groups as to whether to file a consolidated return.

with the problems of consolidated returns, the Treasury might find it necessary to adopt new concepts and approaches to cope with the myriad problems involving intercompany dealings. Congress was most certainly aware that such concepts might not always coincide with the tax rules enacted by Congress governing unitary corporate taxpayers. It also was obviously aware of such decisions as *St. Louis Indcpendent Parking Co.* v. *Houston*, 215 Fed. 553 (8th Cir., 1914) and *McKenny* v. *Farnsworth*, 121 Me. 450, 118 Atl. 237 (1922), which prohibit the delegation of legislative authority to promulgate regulations which are inconsistent with existing legislative enactments. It is not surprising then that when the Senate reviewed the feasibility of permitting the filing of consolidated returns under a statute whereunder the Treasury was delegated the task of issuing legislative regulations, the Senate found it necessary to give taxpayers a real and meaningful choice as to whether they would elect to file pursuant to such regulations. See S. Rept. No. 960, 70th Cong., 1st Sess., C.B. 1939–1 (Part 2) 409, 419.

Thus, another fundamental determination involved in the proposal to eliminate the multiple surtax exemption is whether the consolidated return regulations are to be made mandatory with respect to that group or class of taxpayers whose businesses are such that, for all practical purposes, they are required to operate through a number of corporations. In the consideration of this issue, it is important to keep in mind that the Treasury has extremely broad discretion in the drafting and interpretation of regulations under the consolidated return provisions. The Treasury has recently exercised this discretion in 1965 and 1966 by almost completely revising the consolidated return regulations. In so doing, it has in a number of areas provided totally different rules for taxpayers electing to use the consolidated return provisions than those which Congress has enacted as part of the Internal Revenue Code. The so-called "excess-loss" provisions completely alter the Code rules concerning basis in assets and introduce the concept of "negative basis" which the courts upon numerous occasions have held did not exist under the Internal Revenue laws enacted by Congress. See: *Crane* v. *Commissioner*, 331 U.S. 1 (1947); *Jack L. Easson*, 33 T.C. 963 (1960) modified 294 F. 2d 653 (9th Cir., 1961). Moreover, section 704(d) of the Code reflects the studied position of Congress to reject the concept of "negative basis" in matters of Federal income taxation.

It should be further noted that the "excess-loss" provisions of the new consolidated return regulations under certain circumstances provide for materially different and adverse tax consequences for corporations filing consolidated returns than would occur in the same circumstances for a corporation operating its business activities through various branches. For example, it is possible that under Treas. Reg. § 1.1502–19 a consolidated taxpaying group would, in effect, lose the utilization of an insolvent subsidiary member's net operating loss. Such a result would occur through the creation by use of the net operating loss of an excess loss account and the consequent taking of this excess loss account into income as per the regulation. In similar circumstances, a corporation that was able to operate through various branches would be able to utilize the net operating loss of one of its branches.

The mandatory imposition of the consolidated return regulations is further objectionable in that these regulations impose upon that class of taxpayers which require multiple corporations as a necessary means of conducting business an extremely complex and burdensome set of provisions under which to operate. The present regulations have been described by a number of consolidated return authorities or inordinately obtuse and of uncertain meaning in a number of areas of application. See Cuddihy, *Planning for Consolidated Returns Under The New Regulations*, Prentice Hall Tax Ideas, No. 25,007.

In addition, the elimination of any practical alternative or choice to the utilization of consolidated returns would impose upon taxpayers whose businesses require multiple corporations a variety of uncharted, and highly problematical relationships with minority shareholders. Accordingly, such taxpayers will be held to a higher standard of dealing with minority shareholders than would otherwise be encountered. See *Western Pacific R.R. Corp.* v. *Western Pacific R.R. Corp.*, 197 F.2d 994 (9th Cir. 1952) reversed on other grounds, 345 U.S. 247 (1953); Johnson, Minority Stockholders in Affiliated and Related Corporations, 23 NYU Inst. on Fed. Tax. 321 (1965).

In addition to the uncertainties surrounding their application, the recently adopted consolidated return regulations appear to be contrary to statements of Congressional intent or understanding as to the manner in which the consolidated return provisions would operate. For example, the new treatment of intercompany transactions providing for a "suspense account or deferred gain" concept appears to be inconsistent with Congressional intention and long established administrative practices. See H. Rep. 704, 73d Cong., 2d Sess., pp. 16, 17 (1934) where the Ways and Means Committee noted:

> * * * there is no profit recognized for tax purposes on intercompany transactions, and profits on a product of the consolidated group, passing through the hands of the different members of the group, are not taxed until the product is disposed of by two persons outside the group.

See also H. Rep. 2333, 72d Cong., 2d Sess., p. 135 (1942).

The Treasury's adoption of this system of "suspense account or deferred gains" will create in connection with the administration of consolidated returns interminable examinations of intercompany dealings from a standpoint of section 482 and the Treasury's regulations thereunder. This is indeed anomalous since a basic reason which motivated the Congress to retain the consolidated return provisions was to obviate the necessity of detailed administrative policing of intercompany transactions. The Treasury over the years had maintained that the use of consolidated returns would simplify the administration of intercompany transactions.

IV. *If multiple surtax exemptions are nevertheless repealed, more equitable transitional rules should be provided*

If Congress concludes, despite the prior legislative history and the soundness of the considerations militating against so doing, to eliminate multiple surtax exemptions, it then appears incumbent upon Congress to take several corollary steps to minimize the disruptive financial impact of this fundamental change in the tax structure and to avoid forcing a significant class of taxpayers to file consolidated returns under legislative regulations promulgated by the Treasury (which would in any event be subject to substantial question from a constitutional standpoint). The first step would be to provide for a more gradual transition mechanism than is contained in the House bill or in the original Johnson administration proposal. In essence, it is suggested that the reduction in surtax benefits be made at five percent a year over a 20-year period rather than at the 12½ percent per year reduction proposed in the House bill. The basis of this request for a more gradual transition lies in equitable considerations and the need for carefully studying the various ramifications, some of them known, such as providing a proper legal framework for the drafting and administration of the consolidated return regulations, and the fact that many of the ramifications for changing this rule will undoubtedly be unanticipated.

Moreover, this transition or phase-out period for multiple surtax exemptions should not commence until the basic constitutional problem regarding the consolidated return regulations, discussed above, is satisfactorily resolved.

One way for Congress to resolve the constitutional issue promptly would be to institute a new procedure whereby the problem of excessive delegation of legislative authority to the Treasury Department would be eliminated. This could be done by simply expanding the familiar phrase "Under regulations prescribed by the Secretary or his delegate" to read "Under regulations prescribed by the Secretary or his delegate and approved by the Joint Committee on Internal Revenue Taxation or its delegate." In other words, the initial drafting of the consolidated return regulations would be delegated to the Treasury Department, thus obtaining the full benefit of Treasury thinking and expertise in this complicated area. The retention of the review authority of these regulations by the Congress would insure that these important substantive regulations were fully responsive to Congressional intent.

It is submitted that this procedure would not only cure the constitutional question under discussion but would have the salutary effect of minimizing controversies as to the legality of the numerous complex provisions contained in those regulations and should also tend to enhance the coordination of thinking between Congressional and Treasury tax people, a factor with which Chairman Mills and Congressman Byrnes of the House Ways and Means Committee have recently stated needs further development. See the colliquy between Messrs. Mills and Byrnes and former Commissioner of Internal Revenue Sheldon S. Cohen at the Ways and Means Committee hearings on tax reforms, March 28, 1969, Part 12, pp. 4215–4223.

Another step which should be taken if Congress determines to eliminate multiple surtax exemptions is that liberal transitional rules should be enacted to provide assistance and incentives to multiple corporate structures in the reorganization of their business (to the extent they are able to do so—and possibly they may do so to the detriment of their business operations) to achieve simpler corporate structures. The purpose in doing so would be to eliminate the necessity of satisfying the intricate and complex provisions of the Code governing intercompany transactions between related entities. One thing that could be provided for in this respect is to permit taxpayers to deduct during a transitional period to expenses incurred in simplifying and modifying their corporate structures as a result of Congress' action to eliminate the multiple surtax exemption. Normally, the expenses incurred in connection with corporate reorganizations are treated for Federal income tax purposes as capital expenditures.

Much is heard today about the negative effects of certain existing tax rules upon taxpayer morale. Indeed, this is probably the single most important theme which has emerged during the current tax reform program. However, it appears that relatively little concern has been given to the morale of the taxpayers comprising the business sector of the community. The destructive effect on business morale of eliminating the tax benefits flowing from multiple surtax exemptions is a case in point. It takes years of effort and the risk of much capital to develop a going business. Obviously one of the factors taken into account in formulating and developing the structure of a business is the system of taxation to which it is subject. As above discussed, a number of businesses in this country which compete on a local level in small units have found it necessary to conduct their operations through separate corporate entities in each geographical location in which they function. These corporations have been organized, prices structured, profits planned, etc., taking into account the tax effects of multiple surtax exemptions. The loss of this tax benefit will have a significant economic effect on these businesses.

Clearly no one has a vested interest in an unchanging tax statute. Changing times and varying national needs make it inevitable that our tax structure must correspondingly change. Nevertheless, there are times and circumstances when it is reasonable for taxpayers to rely upon the existing provisions of the Internal Revenue Code and the prior actions of Congress with respect to specific provisions of the Code. In some circumstances, it is proper for taxpayers reasonably to expect that those rules will not be changed in the relatively near future. The instant proposal to eliminate the multiple surtax exemption is a dramatic illustration of such a situation. To repeat, not only once before, but on two separate prior occasions—with a substantial number of years intervening between them—Congress reviewed the multiple surtax exemption and found it acceptable. In view of this history and in view of the fact that nothing new in the way of business considerations or national interests has arisen, if the affected taxpayers have no right to expect that the present Congress will act as had its predecessors on two occasions, it seems that at the very least they are entitled, as a matter of equity, that change be made in such a manner as to permit them to alter their corporate structures with a minimum of financial strain. If more liberal transition mechanisms which we have suggested are adopted, the loss from the repeal of the multiple surtax exemption will be nonetheless real to these taxpayers—it will just be more gradual.

A brief reference to the variety of transitional proposals which have heretofore been advanced is enlightening. Under the House bill, the amount of each additional surtax exemption (over one for the group) would be reduced at the rate of 12½ percent a year. Thus, after eight years (really seven given the effective date of the proposal) each affiliated group of corporations would have only one surtax exemption. The Treasury Department's transitional rule as proposed in April 1969 was more strict. It would have immediately limited the maximum number of surtax exemptions available to an affiliated group of corporations to 100 and each year thereafter reduced the number fifty percent so that after five years, the group would have only one surtax exemption. The Treasury Department under the Johnson administration had still another version of the transitional mechanism—its proposal being spread over an 8-year period—starting with a maximum of 500 surtax exemptions per group, reducing the number to 250 the second year, 100 the third year and thereafter by 50 percent until the eighth year when only one exemption would be available to the group.

This review of the various transitional rules already advanced indicates that there is no one perfect or logical formula. In the final analysis the purpose of such a phase-out mechanism is to do equity. It is submitted that under all circumstances an even and gradual reduction—five percent a year for 20 years—would not be unduly considerate of those taxpayers who would be deprived of multiple surtax exemption benefits. (This, of course, assumes that the phase-out will not begin until the question concerning the constitutionality of the consolidated return provisions is resolved.)

The return to Congress of the authority to issue the consolidated return regulations is also necessary to eliminate problems concerning the constitutionality of the consolidated return regulations. The enactment of a transitional rule permitting the deductibility of reorganization expenses incurred in providing a simpler corporate structure is also necessary to provide basic equity to taxpayers that wish to simplify their corporate structures to avoid the burdensome provisions imposed upon taxpayers with multiple corporate structures.

ARTHUR ANDERSEN & CO.,
Chicago, Ill, September 22, 1969.

Re Statement Regarding H.R. 13270 Tax Reform Act of 1969—Original Issue Discount.

Mr. TOM VAIL,
Chief Counsel, Committee on Finance,
Washington, D. C.

DEAR MR. VAIL: Herewith is Summary of Comments and Recommendations.

The provision in Section 413 of the Bill, which would require the holder of an original issue discount obligation to report such income over the life of the bond, should be eliminated.

BASIS FOR COMMENTS

Our conclusion that the proposal is impractical is based on the following reasons:

(1) A cash basis individual should not be required to employ the accrual method. In many situations there is a "non-parallel treatment" for a transaction between an accrual basis taxpayer and a cash basis taxpayer. Under the proposal, the cash basis individual would most likely not understand why he would be receiving a Form 1099 information return for minor amounts which he would *not* have received on registered bonds: therefore, he would be unlikely to comply with the new rules. In addition to the confusion on the part o fthe taxpayers, the review of returns by the IRS would be more difficult under the new system because the reporting accuracy would have to be checked throughout the years rather than only in the year of disposition.

(2) The proposed system, which would differentiate between registered and non-registered bonds regarding information returns. would add to the basic confusion.

(3) It is difficult to understand why an individual should report income from an obligation when he may be suffering an overall loss on the transaction.

(4) Under the proposed rules, considerable additional practical confusion would result if the original holder would not hold the bond to maturity.

CONCLUSION

The foregoing comments are not intended to indicate approval or disapproval of the remaining portions of the Act: instead, they are only indications of technical areas or unintended effects to unsuspecting taxpayers. This statement is submirted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and recommendations contained herein be made part of the record of testimony relative to the legislative changes contemplated for original issue discount. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

ARTHUR ANDERSEN & CO.,
By JOHN MENDENHALL,
Director of Taxes.

(Whereupon at 11:30 a.m., the hearing was recessed, to reconvene Tuesday, September 30, 1969, at 9:30 a.m.)

TAX REFORM ACT OF 1969

TUESDAY, SEPTEMBER 30, 1969

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 9:30 a.m., in room 2221, New Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Anderson, Gore, Byrd, Jr. of Virginia, Williams of Delaware, Bennett, Curtis, Miller, Fannin, and Hansen.

The CHAIRMAN. The hearing will come to order.

Today we will hear witnesses address themselves to the part of the House tax reform bill which makes sharp reductions in depletion allowances for hard minerals, and cuts back on the tax advantage of production payments of natural resources.

Our first witness this morning is the Honorable William Proxmire, distinguished Senator from Wisconsin.

Senator Proxmire, we are pleased to have you here to continue our running debates on this subject.

STATEMENT OF HON. WILLIAM PROXMIRE, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator PROXMIRE. Thank you, Mr. Chairman. I understand fully the time constraints you are under.

I appreciate the opportunity to testify before the Senate Finance Committee as it considers one of the most important issues facing Congress—tax reform.

I have long felt that the tax privileges of the oil industry constituted one of the most glaring inequities in the entire tax structure. However, because the chairman and I have spent much time discussing this general question and the committee has many other witnesses to hear, I would like to concentrate on two changes in H.R. 13270 which I propose to protect the small, independent oil producers who are doing the actual domestic exploration but which, at the same time, would require the major oil companies that have been enjoying fantastic profits to pay their fair share of the tax burden.

My proposal, which is supported by Senators Brooke, Kennedy, McGovern, McIntyre, Mondale, Muskie, Nelson, Pell and Stephen Young and by the Kansas Independent Oil & Gas Association which represents 1,300 members, makes two changes in the House bill—

1. It eliminates tax credits for foreign taxes which are really disguised royalty payments on overseas production, although it does allow such payments as ordinary business deductions;

2. It establishes a three-tier domestic depletion allowance. It allows the full 27½-percent depletion allowance on the first $5 million of gross income from oil and gas properties, 21 percent on gross income between $5 and $10 million, and 15 percent for everything over $10 million gross: and

3. It would raise at least $475 million a year which is $75 million more than the House bill's ungraduated flat depletion reduction to 20 percent would bring in.

This proposal which is included at the conclusion of my statement is designed to give the small, independent oil producers the incentive they need to explore for domestic sources of oil while, at the same time, closing the major tax loopholes.

Any tax system which requires 2.2 million people under the poverty level to pay Federal income taxes, yet allows Atlantic Richfied to earn over $465 million between 1964 and 1967 without paying 1 red cent in Federal income taxes clearly requires revision. Imagine, gigantic Atlantic Richfield paid less in Federal income taxes than the janitor who cleaned this room last night.

Atlantic Richfield is only one example of the low-income-tax burden borne by the oil industry. The reason the Federal income tax burden on the oil industry is so low is clearly shown when we realize that only 44 to 51 percent of the actual profit of the oil industry is considered to be taxable income, whereas 97 percent of the actual profit for other manufacturing concerns is considered to be taxable income. However, rather than go over the intricacies of the tax structure here, I have included at the end of my statement a copy of an analysis I delivered on the Senate floor.

According to the Treasury Department's "Tax Reform Studies and Proposals," submitted to this committee, the long-term revenue loss to the American taxpayer, as a result of the percentage depletion allowance, was $1.3 billion in 1968. If we include the revenue loss due to intangible expensing, the oil industry received from just these two loopholes a tax benefit worth $1.6 billion in 1968. This money was spent by the American taxpayers just as surely as if Congress had appropriated the money—with only one important difference: No one examined the expenditure to see who was getting it and whether it was worth the cost. I think this point is crucial.

When one compares the congressional scrutiny of programs costing far less than the tax benefits of the oil industry, it is crystal clear that Congress would not have approved anywhere near the $1.6 billion primarily benefiting the gigantic major oil companies. The $1.6 billion in back door spending on just these two loopholes is three times what was budgeted in fiscal 1969 for Federal law enforcement, 15 times as much as the cost of running the Federal judicial system, three times the budgeted amount for school lunch and food stamp programs, five times as much as is budgeted for low-rent public housing, and four times the allotment or the Alliance for Progress.

There is no question in my mind that these tax incentives are probably the mose inefficient way of encouraging domestic exploration and development. Most of the tax incentives are going to the major oil companies, which can accommodate themselves to a changed tax situation quite well. They have the financial wherewithall and knowledge to cope with almost any change in the tax situation, but this is not true for the independent oilmen who seem to be doing most of the domestic exploration and development, if we exclude the outer continental shelf and Alaska. The small oilmen are the ones who are really caught in the cost price squeeze. This is not true for the majors. For example, Standard Oil of New Jersey found enough capital to make Enjay, its petrochemical affiliate, the second largest petrochemical producer in the world without any apparent strain on its capital resources.

My proposal is designed to enable the independent oilmen to continue to explore as they have in the past and, perhaps, with renewed vigor while forcing the major oil companies which have used this gigantic flow of tax-free cash to buy into other businesses to pay their fair share of the tax burden borne by all of us. It would also raise more than three times as much revenue as the Treasury's proposals.

DOMESTIC OIL DEPLETION ALLOWANCE

According to the Treasury Department's tax reform study I mentioned before, the oil depletion allowance is a most inefficient way to encourage the domestic exploration for oil. The CONSAD report upon which the Treasury Department based its conclusions indicated that only $150 million worth of oil at the inflated domestic price was discovered that would not have been found without the incentive of the oil depletion allowance. In other words, the oil depletion allowance and intangible expensing provisions cost the American taxpayers over $10 for every $1 of additional discovered reserves—and this is figured on the inflated domestic oil price which is about $1.50 more per barrel than foreign oil delivered to the United States. So for tax expenditures of $1.6 billion, we encourage the development of only $150 million in oil reserves. How inefficient can you get?

The rationale for the depletion allowance is supposedly rooted in national security. Without the depletion allowance, so the argument goes, we would not explore for the oil which we need in order to protect ourselves from possible interruptions in our oil supply.

This myth was destroyed by the CONSAD report. CONSAD, after a detailed study of the oil industry, found that we would experience a mere 7-percent decline in our discovered oil reserves, from a 12-year reserve to an 11-year reserve. Surely, if the need arose, we could discover the needed reserves within 11 years or, at least, find alternative supplies.

Why then should we continue to pay and pay and pay for something we don't need and only benefits gigantic oil companies fully able to take care of themselves?

The first change I suggest should be made in H.R. 13270 is to include a sliding scale oil depletion allowance for domestic producers so that those most in need of incentives, the small wildcatters, get them. My proposal is to give oil producers grossing less than $5 million a year from oil and gas properties the full 27½-percent depletion allowance, give those oil producers grossing between $5 and $10 million a year a 21-percent depletion allowance and give those oil producers grossing over $10 million a year a 15-percent depletion allowance. These depletion allowances would be applicable only to domestic production; they would not be allowed on foreign production which does not benefit our national security. This would allow the small producers the full benefit of the oil depletion allowance and would help them compete against the major oil companies which have all the advantages big fully integrated companies have over little independent companies.

Along the same line I would like to endorse the provision in H.R. 13270 eliminating the mineral production payments and ABC transactions which allow oil companies to shift taxable income from year to year to minimize even further any Federal income taxes they might owe.

Finally, I would like to suggest to the committee for its consideration a much more radical approach. Much discussion has appeared about the pros and cons of requiring the capitalization of intangibles. I am not suggesting that the committee consider the capitalization of intangibles but, if the committee decides to discuss requiring the capitalization of intangibles, I think they also ought to discuss adopting a direct drilling subsidy. The plan which I have attached to the end of my statement provides a direct drilling subsidy of 25 percent of the intangible costs on exploratory wells. This plan would increase incentives for exploration by 35 percent while, at the same time, bringing in about $285 million a year in new revenue. It directs the incentives to the areas in which they are needed and eliminates them where they are not needed.

FOREIGN TAX CREDITS AND DEPLETION

If national security is really the basis for all the tax incentives enjoyed by the oil industry, I cannot understand why the Internal Revenue Code gives greater tax incentives for foreign exploration and development than it does for domestic exploration and development.

Under the present system, royalty payments disguised as tax payments to foreign governments are written off dollar for dollar against U.S. taxes owed. The only reason for such special treatment seems to be that the mineral rights in these countries are owned by the government rather than private individuals as in the United States. If I were of an ironical frame of mind, I would say that these bastions of free enterprise—the major oil companies—were actually encouraging socialism.

Why should U.S. taxpayers be required to pay taxes to these foreign governments, just because of a quirk in these foreign governments' laws? Make no mistake about it, 50 cents of every dollar paid by the oil companies to these foreign countries is paid by the American taxpayer.

What national security justification exists for that?

This money paid to the foreign countries is clearly a legitimate business expense and should be treated as such. The Internal Revenue Code should allow the oil companies to deduct these royalty payments disguised as foreign taxes from their earnings as a legitimate business expense; but the oil companies should not be allowed to continue to write off such payments dollar for dollar against U.S. taxes owed.

Finally, I think we must ask, What purpose does the foreign depletion allowance serve? If encouragement of domestic exploration and development is the purpose of the depletion allowance, then allowing a foreign depletion allowance is contrary to such a purpose and is clearly contrary to the stated purposes of the oil import program. I am delighted that the House recognized this and eliminated foreign depletion allowances in H.R. 13270.

Between the foreign depletion allowance and foreign tax credits we have encouraged the oil industry to explore abroad to the detriment of domestic exploration. We have, in effect, created a monster. Supposedly, in the name of national security we have enacted tax incentives to explore for domestic sources of oil, yet, the way it works there are even greater tax incentives to explore for foreign oil sources. And, to add the finishing touch, these incentives are theoretically supposed to lower the price of oil. Yet, the oil import program and State market proration laws force the consumers to pay ever higher prices for oil. Thus, not only does the consumer have to pay higher prices for oil than he should, he is forced to bear a great part of the oil industry's tax burden.

The taxpayer has had it. The middle class, the people who live on a salary, can no longer remain the forgotten class, They will no longer continue to subsidize the oil industry by paying high oil prices and by shouldering the oil companies' tax burden. Let us put the oil industry back into a free marketplace and let them compete. The major oil companies are not babies who require constant mothering. They are very powerful. Let us treat them as such.

Mr. Chairman, my proposal is, I think, a moderate one. It will still allow the oil industry to deduct from their gross income their actual costs of foreign exploration and development and their actual cash outlays for royalty payments to foreign countries. At the same time, it will bring in about $2.1 billion a year in new revenue while encouraging domestic rather than foreign exploration which is, after all, the supposed purpose of all the oil industry's tax incentives.

Mr. Chairman, I would appreciate it if it is possible to hold the record open until say the 10th of October for a technical analysis which will be forthcoming?

Mr. Chairman. Thank you very much, Senator. You are the chairman of a committee and you understand the problems that are involved.

Senator Proxmire. I certainly do.

The Chairman. We are trying to report this bill by October 31, and that being the case, I have asked the committee to go along with the procedure whereby we would hear all our witnesses in chief and then if we wanted to call them back to interrogate them we would.

The statement you have made here, Senator Proxmire, illustrates the point I think that if we interrogated you in depth about your views on this matter, no one else would testify this morning. I would hope then that the Senator will come back to answer questions.

Senator Proxmire. You probably have the most difficult job that any committee chairman has in this session.

The Chairman. I am committed to report out a bill as you know. Thank you very much.

Senator Proxmire. Thank you.

(Attachments to Senator Proxmire's statement follow:)

A Program To Increase the Effectiveness of Federal Incentives for Energy Resources Discovery

BACKGROUND

Federal encouragement to the expansion of the nation's resource base is a long standing policy. Implementation of this policy presently includes direct appropriations for geological surveys and support of research and development and an extensive set of income tax incentives designed to favor minerals production. The proposal below is intended to address only a portion of the Federal minerals resource base assurance program, that relating to energy resources. There are two reasons for limiting the proposal to energy resources: energy resources are basic inputs to all stages of the economic process; and the dominant characteristics of the principal energy resource, oil and natural gas, require a continuous high rate of exploration in order to sustain a reliably high level of consumption. The significance and distinctiveness of the energy resources problem is already recognized in Federal programs. Not only are particular expenditure programs designated for oil and coal research and development, but special provisions for the taxation of oil and natural gas have been incorporated in the tax laws.

There are obviously two ways by which to expand the nation's energy resource base: by the discovery of new deposits of energy resources; and by the development of technologies for increasing the recovery of useful forms of energy from known mineral deposits. Presently, the bulk of Federal incentives for energy resources exploration and research are directed toward oil and natural gas, and a preponderant fraction of these incentives are provided via the income tax. Very little Federal support of research and development of technologies for increasing the yield from known mineral deposits is being provided and this is almost entirely in the form of direct expenditures. Since reform of the Federal income tax is now before the Congress, the opportunity presents itself for reviewing and improving the effectiveness of existing tax incentives, and comparing them to the amount of direct expenditure.

PRESENT TAX SITUATION

Of the tax incentives for energy resources discovery and development, those for oil and natural gas are by far the most important. This derives from the fact that, in the cases of coal, oil shale, and tar sands, the other principal sources of energy resources, existing, known stocks are extremely large relatively to current usage. For these minerals, development of economic technologies for their conversion into liquid fuels, not discovery of mineral deposits, is the critical need.

As is well known, the tax incentives for the exploration and development of oil and gas reserves are provided in the tax accounting for investment expenditures relating to discovery and development of reserves. Due to the nature of these minerals, a major fraction of investment expenditures is devoted to well drilling and the equipment of wells. In 1966, for example, the Joint Association Survey (a cooperative petroleum industry endeavor) reported the following expenditures within the United States:

	Amount (millions)	Percent
Exploration:		
Drilling and equipping wells	$832	18.7
Geological and geophysical expense	378	8.5
Land acquisition and rentals	827	18.6
Other	128	2.9
Total, exploration	2,165	48.6
Development:		
Drilling and equipping wells	1,528	34.3
Lease equipment	459	10.3
Improved recovery programs	187	4.2
Other	119	2.7
Total, development	2,293	51.4
Total, exploration and development	4,458	100.0

Under normal circumstances, all these expenditures would be capitalized and treated as the investment cost to be recovered by future production from whatever oil deposits had thereby been discovered and made available for recovery. However, industry practice, reflecting the peculiar technological processes of oil field discovery and the conditions under which individual firms engage in one or more stages of the discovery, development, and production process of the industry, results in normal capitalization of less than the full amount. And, under the tax laws, still less of this investment cost is required to be capitalized and recovered (as depletion and depreciation) from future production.

The major source of difference betwen oil industry capitalization of investment costs and that permitted under the Internal Revenue Code is attributable to the tax treatment of so-called intangible drilling expenses. These expenses include the cost of clearing land preparatory to drilling, the labor and related costs of drilling, etc. In the data above, it is estimated that about 80 percent of the $2,360 million for drilling and equipping exploratory and development wells is considered intangible drilling expense for tax purposes, the remainder being related to depreciable machinery and equipment which is required to be capitalized and recovered over the useful lives of wells. Of course, under normal accounting procedures, and under the tax laws, all non-salvageable costs associated with dry holes would be written-off as an expense. But, under the tax laws, the intangible drilling costs of successful wells also may be written-off as expenses as incurred. Of course, notwithstanding this option under the tax laws to expense depletable investment costs of successful wells, the taxpayer wtih production is nevertheless able to claim percentage depletion in future years.

This then is the substance of the tax incentive to exploration and development of oil gas deposits. The tax treatment of intangible drilling expense applies equally to development drilling as well as to exploratory, and herein lies a significant cause of the dilution of the incentive for exploration, without which there could be little expansion of available oil and gas reserves. The attractiveness of expensing of intangibles to a driller depends upon the likelihood that he will tap an oil pool and thereby become eligible to take percentage depletion against future production income. If he drills a dry hole, his investment cost is lost, and though he has been permitted to deduct his costs (as intangible drilling expense, or dry hold deduction) in arriving at taxable income, this affords him no particular advantage. Now, it is well known that the probability of drilling a sucessful exploratory well is far less than the probability of drilling a successful development well. This follows from the definition of the two classes of wells: "An exploratory well is a well drilled (1) to find and produce oil or gas in an unproved area; (2) to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir; or (3) to extend the limits of known oil or gas reservoir . . . a development well is a well drilled within the proved area of an oil or gas reservoir and completed in a stratigraphic horizon known to be productive."[1] Indeed, over the years 1967–1968 ony 16 percent of wells classified as exploratory were successful while 75 percent of development wells drilled were successful.[2]

Clearly, once a reservoir has been identified by an exploratory well, little more incentive to development is necessary beyond that provided by the marketability of the oil or gas and the prospect of tax depletion deductions to enhance the after-tax return to the developer. Therefore it may be reasonably concluded that much of the tax incentive from intangible drilling expense deductions is channeled to development, where it is less needed because of the availability of percentage depletion, and not to exploration, where some tax incentive designed to recognize the inherent riskiness of exploration and its importance to the maintenance of the national energy resource base would be desirable.

PROPOSED TAX REFORM

Due to the difficulty of consistently identifying expenditures which result in dry holes with producing properties held by taxpayers, it is proposed to continue to permit intangible drilling expenses associated with dry holes to be currently expended. However, it is proposed that intangible drilling expenses

[1] American Petroleum Institute, "Standard Definitions for Petroleum Statistics," July 1, 1969, pp. 27 ff.

[2] American Petroleum Institute, *Quarterly Review of Drilling Statistics for the United States*, for 1967–1969.

associated with successful wells be capitalized for tax purposes and the taxpayer permitted to recover this investment cost through cost or percentage depletion in future years, whichever is more favorable for him.

Finally, in order to direct Federal tax incentives toward exploration for oil and gas deposits, it is proposed that a distinction between exploratory and development wells be established under the tax laws. The Secretary of the Treasury, with the assistance of the Secretary of the Interior, would promulgate regulations defining exploratory wells for tax purposes; it is to be expected they would adapt definitions already established by the American Association of Petroleum Geologists and which have been utilized for well census purposes in recent years. Then, for *all* exploratory wells, it is recommended that a refundable tax credit equal to 25 percent of intangible drilling costs be provided under the Internal Revenue Code. This credit for exploratory wells that turn out to be dry holes would be additional to the expensing of intangibles. In order that maximum effectiveness of this tax incentive be enjoyed by taxpayers engaged in exploration, it is further recommended that no restrictions be placed on the amount of the credit for which a taxpayer may be eligible in a single year, and that unlimited carryforward be permitted. To minimize the possiblity that this incentive will be converted into a tax shelter subject to future attack as a loophole, it is further recommended that the amount of the credit be added to the qualified taxpayer's taxable income. This treatment of the credit has the additional advantage of making the value of the credit slightly larger the lower the income of the taxpayer; as a result, this incentive should provide a positive contribution toward stemming the decline in numbers of independent wildcatters.

The effect of this proposal is shown in Table 1 which compares estimated revenue losses with present law. Altogether, the proposal would entail an annual revenue loss of $510 million as compared with revenue losses of $795 million under present law treatment of intangible drilling expenses; this is a net gain of $285 million in Federal revenues which is available for direct expenditure to stimulate development of economic conversion technologies for coal and oil shale, and to enhance our geologic knowledge of the country, as discussed below, or for general tax reduction. Despite this overall revenue gain, the total tax incentives going to exploration drilling will have been increased $100 million, a gain of more than 35 percent over results under the present law treatment of exploratory drilling expenditures.[3] Naturally, the source which provides this increase in exploration incentives and the remaining $285 million revenue gain is the capitalization of intangible drilling costs on successful development wells. As noted above, present provisions for depletion deductions amply protect the economic interests of taxpayers who operate producing wells.

There are a number of advantages which may be cited in favor of this proposal:

1. It provides a positive incentive to taxpayers to undertake the risky business of exploration. Under present law, the weight of the incentives is in the direction of encouraging further drilling of known deposits rather than discovery of new deposits.

2. It introduces no new problems of definition, adds no complexity to existing law. Intangible drilling expenses, on which the credit is based, is a well established tax category, familiar to both taxpayers and revenue agents alike. While the requirement to capitalize intangibles on successful wells is novel in the tax laws, it conforms with common practice in the oil industry. And though the definition of an exploratory well will also be novel in the tax laws, the distinction is well understood by the industry and amenable to objective determination.

3. It more logically relates tax depletion deductions to the capitalized investment costs they were originally intended to cover. Presently, oil industry taxpayers are required to capitalize virtually nothing to represent their depletable base yet they are subsequently allowed depletion deductions. The proposal would allow generous expensing of all costly dry holes and merely require capitalization of intangibles associated with successful wells, the logical basis for depletion.

[3] See appendix for a numerical illustration of the manner in which this increase in tax benefits comes about under the proposed reform.

PROPOSED EXPENDITURE PROGRAM

It is impossible to design a tax incentive program which will explicitly encourage the performance of research and development needed to develop economic techniques for the conversion of coal, oil shale, and tar sands into liquid fuels. Expensing of research and development expenditures is already provided for in the International Revenue Code, but this is available for all manner of R & D and it is impractical to delimit this privilege so that it may be used to reward only the successful achievement of predetermined results. Similarly, geologic mapping of the country and its continental shelf, if it is to have maximum utility to geologists generally and minerals explorers specifically, must be publicly funded and the results made available to all.

For fiscal 1970, direct appropriations to the Department of the Interior which may be identified with this objective amount to approximately $195 million, a large amount of which naturally funds administration of existing information data, and service functions. This amount, which has not varied appreciably in recent years, could be doubled, with nearly all the increase going to active mapping, research and development, and the construction of oil shale and hydrogenation pilot plants, with the net revenue gain from reform of the tax treatment of intangible drilling expenses, and there would still be $90 million remaining.

This is perhaps not the appropriate forum in which to consider the specifics of a set of increased expenditures directed toward ensuring future energy supplies. However, all who retain confidence in the ultimate virtue of Planning Programming and Budgeting Systems would agree that simultaneous consideration of tax and resources policy objectives is a necessary evolutionary step in the perfection of PPBS. The occasion of minerals taxation reform by this Congress is an unprecedented opportunity to take that step.

TABLE 1.—ESTIMATED ANNUAL REVENUE LOSSES, PROPOSED EXPLORATION TAX INCENTIVE PLAN COMPARED WITH PRESENT LAW

[In millions of dollars]

	Revenue loss under—					
		Exploration tax incentive plan				
				Exploration drilling credit		
Type of well	Present law	Total	Intangible expensing	United States	Other Western Hemsiphere	Rest of world
All wells	795	510	365	100	25	20
Exploratory	280	380	235	100	25	20
Development	515	130	130			

APPENDIX—HOW THE PROPOSED REFORM INCREASES TAX BENEFITS FOR OIL AND GAS EXPLORATION

The tax benefits derived under present law by an average taxpayer who drills exploratory wells with average success are to be compared with the benefits he would derive under the proposed reform of the tax treatment of intangible drilling expenses. Since it is not proposed to alter any other minerals tax provisions, the comparison may be restricted to the tax treatment of intangible drilling expenses.

Assume the average exploratory well driller spends $100,000 which qualifies as intangible drilling costs on a number of wells (he might actually have a one-thirty second interest in 32 wells) and that he experiences the average success ratio of 0.163 (0.837 of his exploratory wells turn out to be dry holes).[1] Under present law, he may expense his entire $100,000 of intangible drilling costs; and if his tax rate is 0.50, he is out of pocket only $50,000 (his tax bill is lower than it would have been by 0.50 x $100,000).

Under the proposal, his intangible drilling costs for exploratory wells are divided into two parts: the one part representing his unsuccessful wells, $83,700, is fully expensed so that he is out of pocket only $41,850 with respect to this deduction, but he also has a taxable grant of 25 percent of this $83,700 which,

[1] Based on United States drilling experience, 1967–68.

at his tax rate of 0.50 nets him $10,462.50 (0.25 x $83,700 x 0.50). Altogether, for his original expenditure of $83,700 on unsuccessful exploratory wells, he is out of pocket only $31,387.50 (the $41,850 after deducting intangibles, less the net value of the credit, $10,462.50). For the other part of his intangible drilling costs associated with successful exploratory wells, amounting to $16,300 in this instance, which must be capitalized, his only tax benefit is the net tax credit $2,037.50 (0.25 x $16,300 x 0.50), so that he is out of pocket only $14,262.50 with respect to this portion of his exploration drilling expenditure.[2] Altogether, then, the taxpayer is out of pocket only $45,650 ($31,387.50 for the unsuccessful wells plus $14,262.50 for the successful wells) under the proposal as compared with $50,000 under present law. In effect, the proposed exploration incentive has reduced the cost of intangibles to this explorer-taxpayer by 8.7 percent.

The difference between this illustrative result and that reported in the text of the proposal is due to two factors: in the revenue estimates, a lower, more realistic average tax rate applicable to the industry was used; this simultaneously reduces the present law tax benefits and increases the value of the credit. Secondly, in deriving the revenue estimates it was assumed that, due to the large volume of excess foreign tax credits held by United States oil companies, a change in the expensing of intangibles on foreign drilling would have no revenue consequences for the Treasury; however, the proposed credit would benefit all foreign exploratory drilling.

[Excerpt from the Congressional Record, June 26, 1969]

SPECIAL TAX TREATMENT FOR OIL INDUSTRY INJURES NATION'S SECURITY

Mr PROXMIRE. Mr. President, I am very grateful to the distinguished Senator from Louisiana for lifting the quorum call. It is most appropriate that he should be the man who should do it, because I am going to speak on oil this afternoon. I expected to make a fairly short speech, and perhaps it will be short.

Mr. LONG. Mr. President, will the Senator yield?

Mr. PROXMIRE. Yes, indeed.

Mr. LONG. If my friend the Senator from Wisconsin can tell me something I do not know about oil, I am very anxious to hear it.

Mr. PROXMIRE. Mr. President, I doubt whether anybody can tell the Senator from Louisiana anything he does not know about oil; he is very expert in this area; as he has demonstrated time and again on this floor, especially when he enlightens this Senator.

Mr. President, the time has come for Congress to take dead aim at the notorious depletion allowance, which too long has served as an obstacle to tax reform. The Senator from Louisiana (Mr. Long) has invited any interested Senator to submit amendments to his committee, and when the tax bill comes to the Senate, I intend to take him up on his offer when the matter is before his committee.

Mr. LONG. Mr. President, will the Senator yield?

Mr. PROXMIRE. Yes, indeed.

Mr. LONG. The Senator is going to get a better chance than that. He is going to get a chance to vote against every businessman in America. We will give the Senator a broad opportunity.

Mr. PROXMIRE. I am sure the Senator from Louisiana will give me every opportunity that I desire to vote on tax legislation, and I certainly do not intend to vote against every businessman in America, I intend to vote against the surtax when it comes up.

Mr. LONG. Will the Senator yield further?

Mr. PROXMIRE. Yes, indeed.

Mr. LONG. Does the Senator know what the biggest loophole is in the tax law? What is the biggest tax loophole?

Mr. PROXMIRE. I would like to know the opinion of the Senator from Louisiana.

Mr. LONG. Capital gains. What is the Senator's opinion on that one?

Mr. PROXMIRE. I think the capital gains law, as presently drafted, could be construed, perhaps, as a loophole. However, I would not want to, although I am

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[2] This assumes that percentage depletion deductions based on future production, which are available under present law and also under the proposal, would always exceed cost depletion of the capitalized intangible drilling costs. In the event there are instances when cost depletion exceeds percentage, as when start-up problems or the net income limitation come into play, the taxpayer would derive additional tax benefits under the proposed reform.

sure some Senators would, repeal it outright, because there is some merit to it.

Mr. LONG. Will the Senator yield further?

Mr. PROXMIRE. I yield.

Mr. LONG. The Democratic policy committee invited Mr. Stanley Surrey, whom they regarded, I assume, as the best tax reformer there is in America, to come down and explain his views on taxes for them, and he did not even mention depletion among the major items. He said capital gains is the biggest loophole there is. Is the Senator prepared to vote to do something about capital gains?

Mr. PROXMIRE. Mr. President, the difficulty with discussing this whole subject is that it is a matter of value judgments. I am shocked and surprised that Mr. Surrey did not mention oil depletion, because I have great respect for Mr. Surrey, and I think this is certainly something that ought to be discussed by as expert a man as he certainly is.

Nevertheless, I will not defer in my judgment as to where reform should come to Mr. Surrey or anyone else. It is not strictly a matter of expertise; it is a matter of where I think there is more need for reform. I think there is more need in the area of oil depletion than in most other areas. Furthermore, I am sure it is the most notorious loophole.

Mr. LONG. Mr. President, I am sure the Senator from Wisconsin is getting ready to respond to my speech, in which I showed with charts and tables that the oil industry pays more taxes than anyone else.

Mr. PROXMIRE. I am sure they pay less than anybody.

Mr. LONG. It took the Senator from Wisconsin almost a month to prepare that speech. I am sure he is now going to argue that they pay more taxes than somebody.

Mr. PROXMIRE. I intend to show that they pay less taxes than almost everybody.

Mr. LONG. The point is that the biggest loophole in the tax law is capital gains, and if you had any advice, the people advising you would tell you the best loophole is real estate, but moneywise, there is more money in capital gains. So it just depends on whether you are talking about quality or quantity. Qualitywise, real estate; quantity-wise, capital gains. It just depends on what you have in mind, whether you are talking about volume or whether you are talking about percentage points.

Does the Senator know, aside from those two, what is the next biggest steal?

Mr. PROXMIRE. May I say to the Senator from Louisiana, he can talk about quality and quantity all he wants to, but what I am saying is we could reduce the oil depletion allowance and could increase revenues to the Treasury with, I think, a fairly modest reduction, by about $600 million. I realize that there are other areas where the return to the Treasury might be greater. You might consider those loopholes. The Senator has properly pointed out two of them which would raise more money, obviously, than if we would remove the oil depletion allowance entirely, and I have not proposed that, nor does any Senator that I know of. I am proposing to reduce it, at most, to 15 percent for the large producers, and not at all for the small ones.

Mr. LONG. Mr. President, I am going to give the Senator an opportunity to vote on the depletion allowance, as I promised him. Is he willing to do something about capital gains?

Mr. PROXMIRE. I will take a long, hard look at it. I shall not vote for any amendment until I find out what it is. It depends on a number of things.

Mr. LONG. You see, Senator, you can afford, in your position from Wisconsin, to tax the oil people, just like I can afford to tax the dairy farmers. We do not have a great many dairy cows in Louisiana. We run some old, catch-as-catch-can beef cows, but in dairy farming as such we are an importer. So I guess I could afford to put a real heavy tax on the dairy farmers.

Mr. PROXMIRE. We just want to be treated like everyone else.

Mr. LONG. The people of the Senator's State are being treated better than most people, if I do say it, even those in the dairy farming business. The Senator's people get the benefit of this capital gains advantage, and so do mine. If the Senator wants a reform in the tax laws, I would like some indication from the Senator from Wisconsin that he would be willing to vote to do something about capital gains, which is the big one in terms of dollars.

Mr. PROXMIRE. Let me say to the Senator from Louisiana that I will be very much interested in his capital gains amendment. I am sure it will be an amendment that will have a great deal of merit; and if I were to guess at this point, I would guess that I would probably support it. But I think that the Senator would certainly expect any Senator to want to take a look at the amendment, and listen to the argument of the Senator from Louisiana, before he makes up his mind.

Mr. LONG. That is fair. Now, quality-wise, the biggest advantage there is in any business seems to be in real estate. Would the Senator be willing to vote to do something about the tax advanages that exist in the real estate business?

Mr. PROXMIRE. I make the same answer as on the other area, as to real estate capital gains. I think it is just a matter of taking a good look at the amendment, and seeing what the very able staff the Senator has been using suggests, what their arguments are, and what the committee report says, and then make up my mind. I just do not know. Again, I think there is a good possibility I would vote for that.

Mr. LONG. If the Senator is interested in comprehensive tax reform, he ought to be interested in the situation of the people who just do not pay anything, just zero.

There is old Mrs. Gotrocks; she inherited stock in the Houdini Co. let us say. The stock is now worth 10,000 times what it was worth, and it looks as though she is going to owe a 77 percent tax on a million dollars of income that she has spent.

So she takes a million dollars worth of her stock, and puts that over into the Mrs. Gotrocks Foundation. Mind you, she has paid no tax on the enhanced value. When she inherited the stock, it was worth only 1 cent a share, and now it is worth $1,000 a share. But she transfers the stock from Mrs. Gotrocks to the Mrs. Gotrocks Foundation, and as a result of transferring $200,000 worth of stock from her own personal account to her foundation account—which she still controls, and votes the stock—and does not invest a penny of it in charity, mind you, she thereby avoids paying any taxes.

It is not well to do something about that? That is a complete fraud and fake, based on a law that was passed to let a nun who had taken a vow of poverty contribute her money to charity.

Is the Senator willing to confine it to the case of that Philadelphia nun, so Mrs. Gotrocks cannot contribute to the Gotrocks Foundation, and get away with deducting $200,000 in taxes?

Mr. PROXMIRE. I believe I would be very willing to support the Senator's amendment. The Senator has made a very able argument in favor of it.

Once again, I would like to take a look at the whole amendment before listening to the argument and making a final commitment. It sounds as if the Senator is making a strong case.

Mr. LONG. Mr. President, not all of the people in the oil business are successful. I know a lot of them who have lost everything that they put in it.

The successful ones pay roughly one-third of their gross income in Federal income taxes. That is Federal taxes and does not count the fact that they pay many other local taxes. For example, they pay 10 percent of their gross income in my State before getting anything. Actually they pay about 43 percent of their gross in taxes.

Is the Senator all that confident that taxpayers who are paying on that basis are favored taxpayers?

Mr. PROXMIRE. Mr. President, at this point I inquire if I have the floor.

The PRESIDING OFFICER. The Senator from Wisconsin has the floor.

Mr. PROXMIRE. I say to my friend the Senator from Louisiana that I will continue to answer him on that subject in some detail. However, I think it would be much more orderly and useful to the Senator from Louisiana and me if I might proceed for another 15 or 20 minutes before replying further to the Senator from Louisiana.

Mr. LONG. Would the Senator answer one more simple question, yes or no?

Mr. PROXMIRE. I will not agree to answer anything until I know what the question is. I will be happy to listen to the question.

Mr. LONG. Will the Senator yield for one question?

Mr. PROXMIRE. I yield for one question.

Mr. LONG. The best I remember, the last time we debated the matter, I took the floor and the Senator left the floor rather than listen to me. Would the Senator be willing to stay around this time?

Mr. PROXMIRE. All Senators have to leave the floor at times. I had been on the floor for a long time on that occasion. I came back later.

The Senator implied that he had driven me off the floor. I suppose that in some ways the senatorial winds can do all kinds of things.

I did have to leave the floor. It is one of those things that we cannot avoid. However, I did come back before the Senator finished.

Mr. LONG. On the last occasion, the Senator refused to yield for a question. I said that if I knew as little as the Senator did, I would not yield. The Senator did not yield, and when I took the floor, he left.

Mr. PROXMIRE. I listened to the Senator for a long time.

Mr. LONG. The Senator did not listen for long.

Mr. PROXMIRE. I will give the Senator a copy of my speech. If he wishes to, he may follow it, and I will be delighted to answer questions later.

Mr. LONG. I make the same promise. When the Senator gets through, I will consider it here today or on some future day. I will give the Senator a response. I enjoy the running debate.

Coming from a State that produces no oil, the Senator is anxious that we pay all the taxes. If I came from a State that produced no oil, I would be eager for oil producers to pay all the taxes.

I daresay the dairy farmers are not paying as much as the oil people.

The running debate will not come to an end.

Mr. PROXMIRE. I am sure the running debate will not come to an end. However, I am convinced that the dairy farmers of Wisconsin want to pay the same taxes as people elsewhere. They want to be treated the same. We do not want to impose any unfair or discriminatory taxes on people who produce oil in Louisiana or elsewhere.

I strongly favor some depletion allowance which would be favorable to them. I favor repealing other taxes. If we give in on the surtax and do not insist and fight for tax reform, we will never get ahead.

Mr. President, I have always felt that the oil industry pays too little in taxes any way you look at it. My distinguished colleague, the Senator from Louisiana (Mr. LONG), disagrees and on May 16 made a speech on the floor of the Senate defending his position.

POINTS TO BE MADE

Because the subject of the oil industry's privileged tax position is so complex, as a guide to my remarks, I would like to list the points I will make.

First. Both the Senator from Louisiana and I agree that the oil industry pays less in Federal taxes than other industries. The Senator from Louisiana indicated that the oil industry pays 24 percent of its net income in Federal taxes, compared to about 40 percent for all industries. Based on his data, my analysis indicates the disparity is even greater: 22.2 percent for the oil industry versus 44.2 for other industries.

Mr. LONG. Mr. President, will the Senator yield?

Mr. PROXMIRE. I will be happy to yield to the Senator from Louisiana after I have finished. I realize that the Senator disagrees with the statement I have just made. I will be delighted to go over it point by point later on.

Mr. LONG. Will the Senator yield for one simple question?

Mr. PROXMIRE. I yield for one simple question.

Mr. LONG. Mr. President, both the Senator and I agree that the oil people pay less in Federal income taxes. If the Senator wants to use the words "all taxes," then I shall prove that they pay more than anyone else.

Mr. PROXMIRE. I am including everything when I say that.

Based on this data, my analysis indicates the disparity is even greater: 22.2 percent for the oil industry versus 44.2 percent for other industries. However, if book pretax net earnings derived from SEC reports, the figures which are used to determine dividends, are used as the measure, the oil refining industry only pays 11 percent of its net income in Federal taxes, compared to 40.8 percent for all manufacturing concerns.

Second. Even if we add all State, local, and foreign taxes, including severance, property, and production taxes, to the Federal taxes paid by the oil industry, its total tax burden is still lower than just the Federal tax burden on other industries.

Third. Our tax policy should not interfere with the forces of the market economy, unless there is a compelling national need to do so. A nonneutral tax policy adopted without adequate justification causes misallocation and waste of our scarce domestic resources and, thus, injures our national security.

Fourth. Even if we accept the thesis that the oil industry needs special incentives to explore for oil, the present tax structure is an inefficient inconsistent, wasteful, and unfair way of achieving this goal. Let me go over each of those adjectives because I mean each of them. It is inefficient because it costs the American taxpayer over $10 in lost tax revenue for every $1 in additional reserves. It is inconsistent because it gives greater tax incentives to explore for oil abroad than here at home. Foreign royalty payments disguised as taxes are written off dollar for dollar against U.S. taxes owed, whereas such payments here are only deductible from income. It is wasteful because it encourages overcapitalization in the oil industry to such an extent that it takes $2 worth of capital in the oil industry to produce what $1 worth of capital will produce in other industries. Finally, it is unfair because it allows big income taxpayers to hide large amounts of income from taxation thereby shifting the tax burden onto those less able to pay.

Mr. LONG. Will the Senator yield?

Mr. PROXMIRE. I wish the Senator would wait until I finish my remarks so that we may have an orderly debate and have some continuity in my remarks.

Mr. LONG. I have been reading the remarks of the Senator. The Senator has mentioned my name time after time. The Senator has declined to yield to me. I will read the speech and I will ask one simple question and leave. It is this simple. Is the oil industry the only industry receiving benefits on foreign income, or does everybody get such benefits?

Mr. PROXMIRE. There is not any question——

Mr. LONG. The answer is yes, is it not?

Mr. PROXMIRE. Comprehensively, the answer is yes.

Mr. LONG. So, the Senator did not know what he was talking about. He said that everybody gets it.

There is a man whispering to the Senator. He is supposed to know something about taxes. Where did he come from?

Mr. PROXMIRE. This is Mr. Martin Lobel, a very able man who has done some very fine work.

It seems to anger the Senator that Mr. Lobel has whispered to me. He is one of the most efficient men I have known on the Hill. If the Senator wants to attack him, I am sure it will not bother Mr. Lobel.

Mr. LONG. What bothers me is that the last time he whispered something in the Senator's ear, the Senator did not say anything.

I ask the Senator what he said this time?

Mr. PROXMIRE. Some of the advantages of having staff members on the floor is that one can listen to what they say. One does not have to do what people whisper in one's ear, whether it be the Senator from Louisiana or Mr. Lobel.

I am sure there have been things that the Senator from Louisiana has whispered in my ear that he would not want me to say audibly on the floor and that there are things I have whispered in his ear that I would not want him to say audibly on the floor.

Mr. LONG. That is a fair proposition. The Senator may make his speech and I will not interrupt him any more.

Mr. PROXMIRE. Fifth. Congress must take immediate steps to cure this cancer in our economy. Congress must develop a much more rational and less expensive means of achieving the supposed objective of our present system—a secure source of oil during emergencies.

TAX FACTS

On the basic issue, Senator Long and I agree. The oil companies do pay a much lower proportion of their earnings to the Federal Government in taxes than do other industries.

Senator Long's figures show that the oil industry pays about 24 percent of its net income in Federal taxes, while the average manufacturing company pays 42 percent of its net income in Federal taxes.

However, these figures overstate the actual tax burden on the oil industry because net income as defined for tax purposes does not include substantial amounts that have been deducted through the use of tax loopholes. Net income for tax purposes or taxable income, if you wish, is usually lower than actual income or in the accountant's term, pretax book net income and the smaller the basis against which tax burden is measured the greater the apparent tax burden.

The taxable income of the oil industry is approximately half of its actual income. According to the Statistics of Income for 1965, published by the Internal Revenue Service, only 44 to 51 percent of the oil industry's actual income—depending on how one treats the tax credit—is considered to be taxable income, whereas 97 percent of the actual income of all manufacturing concerns, excluding the refining industry, is considered to be taxable income. Thus, any attempt to compare tax burdens on the basis of taxable income is going to greatly overstate the true tax burden on the oil industry, even if, as my good friend Senator Long has done, we add to the taxable income the amounts excluded on account of the depletion allowance. The depletion allowance is only one of many tax loopholes enjoyed by the oil industry. The oil industry also enjoys many other tax loopholes such as intangible expensing which allows the oil industry to write off in 1 year expenses that other industries must capitalize over a number of years. Still another privilege which it enjoys is the ability to write off royalty payments disguised as tax payments to foreign governments dollar for dollar against U.S. taxes owed.

A much more accurate comparison of the tax burden on the oil industry as compared with other industries can be obtained from the actual income figures of the various industries published by the Securities and Exchange Commission and the Federal Trade Commission. These figures I want to emphasize represent the actual income of the industries; these figures are the ones used by the companies themselves when reporting their income to their stockholders. Based on these figures, all manufacturing corporations paid 40.8 percent of their pretax earnings in Federal taxes in 1968, whereas in 1968 the petroleum refining industry paid only 11 percent of its pretax earnings in Federal taxes.

Mr. LONG. Mr. President, will the Senator from Wisconsin graciously yield one more time?

Mr. PROXMIRE. Very well; I yield.

Mr. LONG. Would the Senator mind correcting his remarks and say "income tax"? It is Federal income taxes on which these people receive a break. In terms of overall taxes they pay more than anybody else does. As to one particular tax, the petroleum industry does get a break. It is the only way they can operate, considering that they are the most heavily taxed of all taxpayers in America.

So when the Senator says "Federal tax," would he be willing to say "Federal corporate income tax" or "Federal personal income tax," as the case may be?

Mr. PROXMIRE. I shall talk about the total tax burden in a minute. I do exclude, it is true, the Federal excise tax. My assumption is that that is a tax paid by the user of gasoline. When the Senator from Louisiana and I go to a gasoline station and buy gas, we pay taxes. The dealer indicates the amounts of Federal excise tax and State tax.

My computation, according to the way I have figured the tax, is of the amount borne by the user, not by the industry.

Mr. LONG. The Senator is excluding State taxes?

Mr. PROXMIRE. That is correct. I am speaking only of Federal taxes.

Mr. LONG. Would the Senator mind explaining who pays more money to friendly foreign governments than anybody else on earth, so far as industry is concerned? I am speaking about friendly foreign governments. Who pays more taxes to them than anybody else? The Senator can say it in one word. Can he say what industry it is?

Mr. PROXMIRE. That depends on the kind of taxes the Senator is talking about. Is he referring to income taxes? If he wants to construe royalty payments as taxes, as the petroleum industry is able to construe them, so far as the Internal Revenue Service is concerned, it is true that the petroleum industry does make higher payments; that is true. I do not have any figures to vertify that. If the Senator tells me that that is the fact, I will agree that it is.

Mr. LONG. One of the representatives of the biggest overseas oil company in America—I think it is the biggest oil company in America—is a friend of mine who has the same name as mine, although we are no relation. He is a Texan: I am from Louisiana. I spoke with him about reducing the depletion allowance for overseas oil.

He said, "Senator, you can reduce it all you want to: but after the foreign governments get through 'putting it to us,' we have so many excess tax credits to carry over we will not owe any money here. Cut our foreign depletion all you want to and we still would owe you nothing. The same, however, would not be true of some smaller companies." And what does the other fellow pay to foreign governments? All other countries tax the foreign operations of their companies on a more generous basis than we tax ours—or in some cases do not tax them at all. I think the Senator from Wisconsin knows that, does he not? If he does not, he ought to find it out. Let the Senator's assistant whisper it in his ear.

Mr. PROXMIRE. I will ask Mr. Lobel to take a seat on the couch.

The PRESIDING OFFICER (Mr. SAXBE in the chair). The Senator from Wisconsin has the floor. Does he yield to the Senator from Louisiana?

Mr. PROXMIRE. No: I shall continue with my speech.

Mr. LONG. Does the Senator mean that he is not going to answer my question?

Mr. PROXMIRE. No; I shall not yield further until I have finished my speech, which will be in a relatively few minutes if I am not interrupted.

As a matter of fact, even if we use Senator Long's figures, the disparity between the tax burden on the oil industry and other industries is greater than he has indicated. An accurate comparison of relative tax burdens requires that we exclude the oil industry from the figures for all industries, otherwise the low tax burden on the oil industry which has such a large percentage of all industries' profits will drag down the average tax burden on all industries. Likewise, I have added back into the figures for the oil industry the approximate amount of tax revenue lost because of intangible expensing. On this basis, using Senator Long's own figures, we find that the Federal tax burden on all industries, exclusive of the oil industry, amounted to 44.2 percent of their income, while the tax burden on the oil industry, which is admittedly overstated, amounted to only 22.2 percent.

TOTAL TAX BURDEN

I now come to the subject of the total tax burden. The Senator from Louisiana has just raised the point about taxes by foreign governments.

Even if we include State and local and foreign taxes to the Federal income taxes paid by the oil industry, the oil industry pays less in taxes than most industries pay in Federal taxes alone.

Senator Long inserted a table beginning on page S5261 in the May 16 Congressional Record showing the total tax burden, including State, local, foreign, and Federal taxes of some of the major refiners. These figures include severance, production, and property taxes which, as Senator Long quite correctly pointed out, my previous figures did not include.

Because I have a small staff, I could not go through all the figures as Senator Long's Finance Committee staff did. However, because the amount of taxes paid by Atlantic Richfield seems to be a bone of contention, I did examine those figures in detail. My analysis indicates that Senator Long inadvertently overstated the total tax burden on Atlantic Richfield and, I would assume, on the other oil companies reported.

For example, according to Senator Long's table, Atlantic Richfield paid no Federal taxes on a net pretax income of $145,259,000 in 1967. It supposedly paid 10.5 percent of its income, or $15,254,000, in foreign and State taxes. It also supposedly paid 22.6 percent, or $32,991,000, of its income in severance, production, and property taxes. However, even if we assume that the foreign taxes are really taxes and not disguised royalty payments, these percentages greatly overstate the tax burden on Atlantic Richfield.

In order to find out what percentage of its net income Atlantic Richfield paid in taxes we have to find out what its net income was before taxes. This is done by taking the after tax net income and adding back the amount of taxes paid by Atlantic Richfield.

I can understand how the Senator from Louisiana (Mr. Long) became confused. According to Atlantic Richfield's annual report for 1967, its pretax income was the figure quoted by the Senator from Louisiana, $145,259,000. However, it also stated that its after tax income was $130,005,000. This means that Atlantic Richfield only added back the foreign and State taxes. It did not add back the severance, production and property taxes which the Senator from Louisiana (Mr. Long) has included in his chart. If we add back all the taxes paid by Atlantic Richfield to its after tax income, we find that its total tax burden is much lower than indicated.

Atlantic Richfield paid the following percentages of its total pretax income in taxes in 1967:

Federal taxes	0
State and foreign taxes	8.6
Severance, production, and property taxes	18.5

This means that Atlantic Richfield paid a grand total of 27.1 percent of its income in all taxes, Federal, State, local, and foreign. Compare this with just the Federal tax burden borne by the average manufacturing company of 40-plus percent. And they, too, must pay State and local taxes as does the oil industry, probably at a higher rate because of their greater payroll taxes, and so forth.

TAX POLICY GOALS

Although the analysis of Senator Long's figures shows conclusively that the oil industry does not pay any where near the amount of taxes, Federal, State, local, or foreign, paid by other industries, we ought not to become lost in figures. We ought to look behind the figures. We ought to examine the tax policies which allow the oil industry to escape taxes paid by other industries, what the consequences are, and whether they can be justified.

The Federal income tax is perhaps the best measure for comparing relative tax burdens in various industries since it is by far the most important tax on return to invested capital. As such it should be as neutral as possible; that is, the return to capital invested in one use should not be taxed more heavily than capital invested in another use—unless there is an overwhelming national need.

In the United States, our economic policy has been to rely upon the market forces to allocate scarce economic resources and to intrude upon the market forces only when there is a compelling need to do so. Unequal tax treatment is a clear intrusion upon market forces. If Federal taxes treat income from a certain industry more favorably than other industries, over time under competitive conditions, capital will flow into the favored industry until the return on capital in that industry is equal to the return from capital invested in less favored industries. This leads to a misallocation of scarce capital, inflationary pressures, and waste.

If I may quote from Professor of Economics Walter J. Mead's, testimony before the Senate Antitrust and Monopoly Subcommittee:

"The effect of favored tax treatment is to reduce tax costs for oil companies relative to firms in other industries. These measures taken together substantially raise the expected after-tax profit rates on oil industry exploration and development rates in what would otherwise be submarginal uses of scarce capital. Investment in petroleum exploration and development is indeed expanded to the point where the after-tax return is approximately equal to that which may be obtained on alternative uses of capital * * *

"Oil industry spokesmen have defended their various subsidies with the question 'If we receive all the subsidies which our critics allege, why is our rate of return on invested capital not substantially higher than other nonsubsidized industries?' The answer to this question is that a subsidy will raise the profit rate at the point in time at which it is conferred.

"Its effects, however, are eroded away with time a producers react to their more profitable situation by expanding into otherwise submarginal areas. This expansion leads to a decline in the rate of return toward a normal yield and to resource misallocation as well."

Mr. President, what I am saying is that the subsidy to the oil industry does not result in higher profits. It results in misallocation of resources as more capital enters the oil industry, to take advantages of the tax privileges which the industry enjoys.

NATIONAL SECURITY AND OIL TAXES

"The supposed justified for the special treatment enjoyed by the oil industry is national security although the recent attack on the Treasury Department commissioned study of the oil depletion allowance by the Mid-Continent Oil and Gas Association seemed to be based on the premise that if we change the depletion allowance the price of gasoline will go up.

"The catechism chanted so long by the oil industry that they actually believe it is that if the oil industry does not have all these special tax breaks and other governmental intrusions into the market on behalf of oil then our country would be in dire straits—we would become utterly dependent for oil upon those rascals in the Middle East who are just waiting for that to happen so they can shut us off."

First, a few facts about the domestic oil industry ought to be established. It is a very healthy and powerful industry by any criteria. In 1968 the combined net profits of the 12 largest U.S. oil companies was just a fraction under $5 billion. Each of those 12 companies, moreover, has set new profit records in each of the last 4 years. Just 4 years ago, the profits of these 12 companies total $3.7 billion. During that short span of time, they have, thus, increased their profits by just under $1.3 billion—a 33.5-percent increase.

According to a survey by the First National City Bank of New York published in its April 1969 Monthly Economic Newsletter, a total of 2,250 manufacturing companies showed a net income of $26 billion in 1968. Of the 2,250 companies, the 99 oil companies had a total net income of $6.1 billion or almost 25 percent of the after tax earnings of the entire list. And, according to the same survey, the oil companies as a group enjoyed the second highest return on sales of 9 percent, almost twice the average return for all companies surveyed. Although the oil industry's return on invested capital was 12.8 percent, just under the 13.1-percent average for the entire 2,250 companies, this is the result of our tax policy as was indicated in Professor Mead's testimony. What happens is that capital comes into the hands of industry to achieve that purpose.

Even if we accept the thesis that our national security requires special incentives to encourage domestic exploration for oil, the present tax incentives are inefficient, inconsistent, wasteful and unfair ways of achieving this goal. I will not touch upon the other governmental intrusions into the marketplace on behalf of oil which accentuate the waste of scarce capital such as the mandatory oil import program and State market proration laws which guarantee high oil prices, because I have spoken about them before. However, I do not think we ought to forget that the oil industry is the beneficiary of many governmental favors in addition to all those tax breaks.

No one, least of all myself, would deny that national security should be our prime consideration. However, all the governmental distortions of the free marketplace to benefit the oil industry have actually been impairing our national security. Our national security requires that we have a strong economy which in turn requires that we do not waste our resources. Here we have governmental policies which affimatively encourage waste of scarce capital and, I might add, depletion of our natural resources all, irony of ironies, in the name of national security.

INEFFICIENCY

Almost all the tax benefits enjoyed by the oil industry are tax credits. These are general policy tools which benefit any activity that qualifies under the particular tax provision. Direct appropriations or expenditures, on the other hand, can be as selective or as broad as Congress wishes.

The tax policies we have now are supposed to encourage the exploration for domestic sources of oil, yet they are so general the oil industry receives tax benefits for activities they would have undertaken even without the tax breaks. In other words, although tax credits are supposed to subsidize the exploration for oil they also subsidize all the other activities of the oil companies which they would have undertaken even without the tax subsidy.

The oil depletion allowance and intangible expensing in 1968 cost the American taxpayers $2.25 billion in lost tax revenue according to the Treasury Department's Tax Reform Studies and Proposals submitted to the Finance Committee. However, in order to be fair to the oil industry, I think I ought to use the estimated long range revenue loss of $1.6 billion a year. This $1.6 billion was spent just as if Congress had appropriated it with one big difference: Congress had no say in how it was spent. The big problem with such "back door spending" is that it is seldom reviewed by either Congress or the executive branch, accurate data on its costs and benefits are often difficult to obtain, and too frequently it is wasted on activities which would have been undertaken without it.

This point may be seen easily when we compare the congressional scrutiny devoted to the money spent because of the depletion allowance and the money directly expended for other projects costing far less. The $1.6 billion in back door spending on the oil depletion allowance and intangible expensing is three times what was budgeted during fiscal 1969 for Federal law enforcement, 15 times as much as the cost of running our Federal judicial system, three times the budgeted amount for school lunch and food stamp programs, five times as much as is budgeted for low-rent public housing, and four times the allotment for the Alliance for Progress.

The percentage depletion allowance is an extraordinary tax benefit because it permits the tax-free recovery of an average of 19 times the original investment in an oil well. For this reason, the percentage depletion deduction is a subsidy, not merely a mechanism for the recovery of capital investment. In addition, that portion of the percentage depletion deduction which represents ordinary tax-free recovery of capital investment costs is usually recovered more rapidly than would be allowed by the usual depreciation methods which other industries are required to use. Thus, percentage depletion confers two benefits: deductions about 19 times in excess of actual costs, and accelerated deductions of initial costs.

It is also remarkably inefficient. The Treasury Department estimated in its study:

"The Federal Government is paying, in tax benefits, about $1.6 billion for resources which the market values at $0.15 billion."

In effect, we are paying over $10 for every $1 in additional oil reserves.

But, says the oil industry:

"If we eliminate the depletion allowance our reserves will disappear and we will become dependent upon those who control middle eastern oil."

The Treasury Department analysis indicates that this is just not true. If the depletion allowance were completely eliminated, the Treasury Department report estimates that instead of a 12-year oil reserve we would only have an 11-year reserve. Surely, this is enough time to compensate for any conceivable interruption of our oil supply.

Finally, I might add, the depletion allowance feeds the fires of inflation. We saw, just a few months ago, how the oil companies raised their prices for crude oil in order to get a larger depletion allowance and thus hide more of their income from taxation.

The intangible expensing provisions of the tax code are also extraordinary because they permit the immediate tax-free recovery of most of the costs of exploring and drilling for oil. Other industries can only recover their capital investments over the approximate life of the capital equipment. For example, a farmer in Wisconsin who buys a tractor can only recover his capital investment in it over a period of years as the tractor wears out. If, however, he had enough money to invest in oil exploration and drilling, he could recover his capital investment in 1 year.

As a matter of fact, the American consumer does not even get the benefit of the lower oil prices that he should from these tax subsidies. Theoretically, the oil depletion allowance, intangible expensing, and all the other tax loopholes benefiting the oil industry, are subsidies paid for by the American taxpayer in increased taxes and should result in lower oil prices. Yet, the anachronistic State market proration laws—laws which forbid the oil companies in Texas or Louisiana to pump at more than 50 percent of capacity, and, as a matter of fact, Texas just cut their allowable reduction of 400,000 barrels for July, because that is all the oil companies wanted to buy—keep the price of oil at artificially high levels and thus deprive the taxpaying consumers of the lower prices they should be getting.

I can think of no better way to sum up the deficiencies of these tax provisions than by quoting from the Treasury Department's tax study which I mentioned before:

"Percentage depletion is a relatively inefficient method of encouraging exploration and the resultant discovery of new domestic reserves of liquid petroleum. This is in part due to the low sensitivity of desired reserve levels to the price subsidy represented by percentage depletion, and in part to the inefficiency of the allowance for this purpose, since over 40% of it paid for foreign production and non-operating interests in domestic production."

The report went on to note, and I think this is very significant, because the report is the first impartial analysis of the cost of oil's special tax privileges to the American taxpayers—

"The investigations reviewed during the course of the study were in substantial agreement that the current situation was one of economic inefficiency, and that *any changes were almost certain to be beneficial to the economy in the long run.*"

Let me repeat that:

"Any changes were almost certain to be beneficial to the economy in the long run."

There are so many changes, Mr. President, downward in which the depletion allowance would be reduced.

INCONSISTENT

Although the supposed justification for all of oil's tax loopholes is the alleged need for more incentives to explore for domestic sources of oil, our tax policy is contrary to such a goal, because it gives greater incentives to explore in foreign countries than here at home. This seems unbelievable, but it is true.

Royalty payments which are disguised as taxes to foreign countries, particularly in the Middle East, the area which is most likely to cut off our supplies of foreign oil, are credited against U.S. taxes owed. This means that every dollar paid by the oil companies to these foreign countries in disguised royalty payments is $1 less they owe to the U.S. Government. Yet, such payments here in the United States are only deductible from ordinary income, not from the amount of taxes owed by the companies.

The American consumer and taxpayer is being taken both ways. Not only is he bearing a great part of the oil industry's fair share of the tax burden, because of these great tax incentives to explore abroad, but he is also prevented from benefiting from all this inexpensive foreign oil, because the oil import program limits the amount of the inexpensive foreign oil that can enter the U.S. market. All this is done in the name of "national security."

Surely, this type of thinking could not pass the muster of any rational man. The only reason that the over $1.6 billion in taxes is being spent this way is that Congress has not really reviewed the oil tax situation since 1926, when the depletion allowance was set at its present level. This is the great fault of tax credits. They are not subject to continuing scrutiny and justification. They grow and imbed themselves in our economy until any connection with their original rationale is purely coincidental.

Surely, Congress can devise some much cheaper way to provide for a secure source of oil during emergencies. Between the oil import program and all of oil's tax loopholes, the American consumer and taxpayer is being forced to subsidize the oil industry by over $7 billion a year. It is unbelievable that we cannot devise a much cheaper and more effective way of protecting ourselves from emergency interruptions of our oil supplies.

WASTEFUL

Because all these special tax privileges have riddled the economic fabric of our country, gigantic sums of scarce capital have fallen through these loophoes and been wasted. I have already touched upon this point before and do not wish to belabor it, but I do wish to point out the findings of one of our leading tax experts, Arnold Harberger. Writing for the Joint Economic Committee in its study entitled "Federal Tax Policy for Economic Growth and Stability," he indicated that it takes about $2 worth of capital investment in oil exploration to produce as much product as $1 of capital invested in other industries. This, in effect, confirms Professor Mead's statement about the uneconomic conditions in the oil industry because of the oil loopholes. As a matter of fact, Professor Adelman of MIT estimates that if these economic inefficiencies which are encouraged by our tax laws could be eliminated, the price of oil could drop by as much as $1 a barrel. Professor Steele of the University of Houston went even further. He indicated that about 95 percent of our present output would still be produced if the price of oil dropped from its present level of about $3.50 a barrel to $2 a barrel.

How can we encourage these uneconomic conditions in the name of "national security"?

UNFAIR

Our tax policy is supposed to be fair. Fairness in taxation means two things: First, taxpayers with similar incomes should pay similar taxes, and second, persons wth higher incomes should be taxed more heavily than persons with lower incomes.

Our tax policy so far as oil is concerned is not fair to the American taxpayer. Those taxpayers who derive their income from oil pay lower taxes, if any, than those who get their income from other sources. This is not fair. The source of the income should not make any difference as to the amount of taxes paid. Why should a person whose income is from wages or salary have to pay more in taxes than someone who gets his income from oil?

Second, all the oil tax loopholes allow many high-income taxpayers to escape from paying taxes or from paying their fair share of taxes. This was pointed out dramatically by former Secretary of the Treasury, Joseph W. Barr, in testimony before the Joint Economic Committee. One hundred and fifty-five individuals with adjusted gross incomes exceeding $200,000 in 1967 paid no Federal income tax.

Now, I do not claim that all these 155 individuals with incomes over $200,000 who did not pay any Federal taxes relied exclusively on the oil tax loopholes to escape taxation; but I do say the oil tax provisions are one of the most important loopholes through which this income escaped taxation.

I think that we in Congress should also pay close attention to the statement of Henry H. Fowler, Mr. Barr's predecessor as Secretary of the Treasury:

"Under present law, 2.2 million families with incomes below the poverty level are required to pay Federal income taxes. * * * On the other hand, there are a sizable number of individuals with very high incomes who pay little or no income tax. Indeed, although the Federal income tax is designed and understood to be progressive, the fact is that many persons with incomes of $1 million or more actually pay the same effective rate of tax as do persons with incomes only 1/50th as large."

How can we in Congress allow a system to continue which taxes 2.2 million families with incomes below the poverty level, yet allows people with incomes over $200,000 a year to escape paying any taxes at all? Why should those below the poverty level be forced to pay the taxes that should be paid by the oil barons?

WE MUST DO BETTER

If I may quote from the Department of the Interior's study, "U.S. Petroleum Through 1980":

"(Government) has sought to encourage discovery of oil and gas by favorable tax treatment, by limiting imports, by making public lands available for mineral leasing, and by regulating production to provide order and stability while avoiding the physical waste of resources. In doing so it has involved itself in matters of both supply and price."

We have achieved the goal stated by the Interior Department's report; we have encouraged the discovery of oil and gas. But at what costs?

The cost to the American consumer and taxpayer for just the oil import program and some of the tax loopholes is in excess of $7 billion a year.

The justifications for such excessive costs are unconvincing.

I ask unanimous consent that articles by Patrick Young of the National Observer and Spencer Rich of the Washington Post be printed in the Record at the conclusion of my remarks.

The PRESIDING OFFICER. Without objection, it is so ordered.

(See exhibit I.)

Mr. PROXMIRE. Mr. President, both of these reporters are fine, hardnosed newspapermen beholden to no one and both of these reporters reached the conclusion that the oil industry's defense of its favored position has not been persuasive.

I cannot believe there is not a more efficient and less expensive way of providing for a secure supply of oil during emergencies than the present system. The cost of the present system has run away because its costs have not been visible. I can assure you that if Congress had to make a direct appropriation for such a program the costs would not be anywhere near $7 billion a year. Certainly we need oil for our national security, but we need lots of other things for our national security, too. One of these is a strong economy which does not waste its resources.

I think quite clearly that the oil industry should be placed on an even footing with other industries. The oil tax loopholes should be closed. This would go far toward quelching the impending "taxpayers revolt" by putting fairness back into the tax system.

To conclude, I think then we ought to find out, as the Shultz study of the oil import program seems to be doing, what are our actual needs for oil during emergencies. We should then ascertain what is the most efficient, inexpensive way of assuring that supply. It might be a grant to develop the technology needed to produce oil from oil shale economically or it might be cheaper to discover oil pools on Federal land and then keep that oil in reserve until needed.

Whatever solution we decide upon, one thing is clear: The present privileged position of the oil industry must go.

[From the National Observer, May 26, 1969]

EXHIBIT I

THE UNIQUE STATUS OF AN INDUSTRY: HOW TAX BREAKS HAVE NOUNISHED THE OIL BUSINESS

(NOTE.—This is the last of a series of articles that explore firsthand and in depth the oil industry's singular position and prerogatives in America today. The articles were prepared by staff writers August Gribbin, Michael Malloy, and Patrick Young and senior editor Edwin A. Roberts, Jr.)

"In the late Nineteenth Century, the amassing of great wealth from oil was enhanced by the easy ethics of the age. In more recent times, many new oil fortunes have arisen and swelled, and they have swelled in fair measure because the industry enjoys an assortment of tax breaks that no other business can match.

"Consider:

"Atlantic Richfield Co. reported income before taxes of $377,942,000 in the years 1965 through 1967, but the company paid no Federal income taxes.

"Standard Oil of California reported income before taxes in 1967 of $513,067,000 and paid $6,000,000 in Federal corporate income taxes, or 1.2 per cent.

"How can this be done? How is it possible to earn so much and pay little or no Federal income taxes? The answer is that the Federal tax structure provides a host of unusual tax sanctuaries for the oil industry.

"These tax sanctuaries are related to the controversial Machiasport plan, by which Occidental Petroleum Corp. hopes to erect a huge refinery in the tiny town of Machiasport at the northeastern tip of Maine. The plan represents a sophisticated attempt to hurdle the Federal import quota system for oil. It is the import quota system, which was explained in detail in The National Observer of May 5, as well as restrictions on domestic production, which were examined in The National Observer of May 12, that combine with petroleum's special tax breaks to give the U.S. oil industry a unique status in the economy—and to force the American consumer to pay artificially high prices for many oil products.

"It is this unique status that the battle over Machiasport has placed in the spotlight, and the industry is preparing to meet assaults from any direction.

"CASH FOR CHANCY PROJECTS

"Uncommon tax advantages provide the industry with an uncommonly large cash flow, which the industry argues is required for its gigantic and often chancy operations. What are these tax advantages?

"Take a look at the more important ones:

"Percentage depletion

"Oil and natural gas well operators may deduct 27.5 percent of the gross revenues of each property before paying taxes, unless this figure totals more than 50 percent of the net income of the property before deducting the depletion allowance. Thus, if gross revenues on a property total $100,000, the producer may take $27,500, before figuring his taxes, so long as the net income of the property after expenses is $55,000 or more. If however, the net income was, say, $50,000, the producer would be limited to 50 percent of that, or $25,000.

"Intangible drilling costs

"These include such costs of developing a producing well as wages, fuel, repairs, hauling supplies, and other expenses that do not have a salvage value. These 'intangibles' may be deducted from gross revenues the first year. Similar expenses incurred by other manufacturers must be capitalized and written off over a number of years.

"Foreign tax credits

"U.S. companies operating abroad may claim credit for taxes paid to foreign governments on nearly a dollar-for-dollar basis. Thus if a company owed $75,000 to Uncle Sam on its profits earned in, say, Saudi Arabia and had paid $80,000 in taxes to the Saudi Arabian government, the foreign-tax credit would eliminate the taxes on that operation due the U.S. Treasury. Critics, however, say that taxes paid Middle East governments by U.S. oil companies are based on artificial prices, and that some of these taxes should be treated as expenses of doing business and should not be allowed to fully wipe out the companies' U.S. tax debt.

"Western Hemisphere trade deduction

"This provision allows U.S.-owned companies doing 95 per cent of their business outside the United States but within the Western Hemisphere to a special deduction in figuring their Federal taxes. In effect, it reduces the tax rate by 14 points, currently from 52.8 per cent to 38.8 per cent. This is done before any foreign tax credits or depletion allowances are taken. It is a provision that mostly favors companies in the business of extracting minerals. Like oil.

"These sanctuaries are used in combination with still other advantages. An example will indicate what a resourceful accountant might do for his oilman client.

"Assume the oilman drills a well that costs $100,000 and produces gross revenues of $100,000 in its first year. Between 75 and 90 per cent of his expenses will be intangible drilling costs, which can be written off in the first year. These include rental of a drilling rig and the salaries of crewmen. Assume intangible costs of $80,000 and production costs of $5,000. The gross income of $100,000 minus $85,000 in intangibles and production costs would leave an income of $15,000.

"But he would not pay income taxes on $15,000; he would pay them on $7,500.

"Here's why: The depletion allowance for oil and gas is 27.5 percent of the gross income, but this may not exceed 50 per cent of the net income of the property. In this example, the depletion allowance equals $27,500. But the oilman, because of the 50 per cent limit, could claim only $7,500 in depletion. If he chose this method, therefore, the oilman would have a taxable income of $7,500.

"The next year, however, assuming again a gross revenue of $100,000 and production costs of $5,000, the oilman could take his full percentage depletion allowance of $27,500 and his taxable income would be $67,500.

"But a technique known as 'carved-out production payments' would save the operator many tax dollars. In his first year of operation, the oilman's intangible costs limited the amount of depletion he could claim to $7,500. But if he hold his second year's production in advance—that is, during his first year of operation—he would have a first-year gross income of $200,000. And a gross income of $200,000 minus intangibles and production costs of $85,000 would result in a first-year net income of $115,000.

"The percentage depletion allowance would equal $55,000 (27.5 per cent of $200,000) and the oilman would not have reached the limit of 50 per cent of net income, or $57,500. Thus, although his gross income for the first year was $200,000, he would have a taxable income of only $60,000.

"There is yet another aspect of this device. Since the oilman has already received payment for the oil he produces in his second year of operation, he will have no income at all in his second year. But he will have production costs of $5,000, which he can then report as an operating loss. And so, he will be able to claim a tax refund from the Government on this 'loss' by carrying it to earlier years without affecting the 'loss' to income from other sources.

"The net effect of this maneuver is that the oilman would have taxable income—after selling the production payment—of $60,000 in the first year and minus $5,000 in the second year. Without the sale of the production payment, his taxable income would be $7,500 in the first year and $67,500 in the second year. The sale of the production payment thus reduces his taxable income for the two years by $12,500.

"There is another form of production payment called the 'ABC deal.' It does not lend itself to simple explanation, but perhaps a sample offered in a U.S. Treasury Department report makes the effect sufficiently clear.

"'In a recent ABC transaction,' reports the Treasury Department, 'a major oil company purchased all the coal properties of another corporation, subject to a reserved production payment of $460,000,000 payable out of a large percentage of the net profits to be derived from the operation of the coal properties by the buyer. Under present rules, the buyer excludes from income the $460,000,000 of profits derived from its operation of the coal properties and paid over to the holder of the production payment.

"'This feature alone represents a Federal income tax saving to the oil company of approximately $175,000,000 over the payout period, or an annual tax saving of between $10,000,000 and $18,000,000 per year depending on the actual length of the payout period. (It was estimated that it would take 7 to 16 years to discharge the production payment out of profits derived from the operation of coal properties.)

"'In addition, all of the costs of mining the coal used to discharge the production payment were deducted by the buyer even though it capitalized those costs on its books as a cost of acquiring the coal properties.'

"The Treasury says that in 1966, ABC transactions totaled $1.85 billion (for all extractive industries) and resulted in a loss of revenue to the Federal Government of $85,000,000. Carved-out production payments totaled $540,000,000 in 1966—up from $214,000,000 in 1965—and cost the Federal Government $10,000,000 in revenue.

"FROM THE JOHNSON YEARS

"These figures are taken from reports issued by the Treasury Department during the Johnson Administration; the reports included a long list of tax-reform proposals. They make up four volumes titled *Tax Reform Studies and Proposals U.S. Treasury Department*. The first three volumes are Treasury Department studies. The fourth is an examination of tax provisions affecting the oil and gas industry, prepared for the Treasury by the CONSAD Research Corp. of Pittsburgh.

"Neither the Johnson nor Nixon administrations has endorsed the far-ranging reforms sought by Treasury specialists. But the reports were sent to Capitol Hill and released jointly by the House Ways and Means Committee and the Senate Finance Committee.

"Included in the Treasury's reports is this comment:

" 'In effect, the price of crude oil in the United States is being underwritten by import controls, by state controls on production, and by favorable tax provisions. * * *'

"The oil industry's tax advantages affect not only its less privileged competitors but the whole national economy as well.

"The CONSAD report states: The oil and gas producing industry accounts for about 1.5 per cent of the Gross National Product. [Reckoned at an annual rate of $93.4 billion in the first quarter of 1969.] By most conventional standards it is not a highly concentrated industry, but with so enormous an output, each of the largest firms is a giant in the economy. The five top dometsic producers together account for 20 per cent of the output, the top 20 for 50 per cent.

"According to the U.S. Bureau of Mines, the value of crude oil at the wellhead in 1967 was $9.4 billion, and the value of natural gas was $2.9 billion. The value of natural gas liquids, liquid fuels extracted from natural gas, was $1.2 billion. The value of products shipped from U.S. refineries in 1967—the latest year for which figures are available—was $20 billion.

"The oil industry concedes that it is very big and very important. Indeed, its size and essentiality are often cited by industry spokesmen to defend its preferential treatment by the tax laws, just as they are cited to defend the import quota system and state-enforced controls on domestic production. What the industry prefers not to emphasize are industry profits.

"Consider some statistics contained in the 'Monthly Economic Letter for April of this year, published by the First National City Bank of New York City. A survey of 2,250 manufacturing companies, divided into 41 categories, showed a net income in 1968 of $26 billion. Ninety-nine oil producing and refining companies had a total net income last year of $6.1 billion, or almost 25 per cent of the after-tax earnings of the entire list of 2,250 companies.

"Significant, too, is the percentage of return on sales, also calculated in the First National City Bank study. Fifty-five aircraft and space companies had a return of 2.8 per cent. Eleven auto and truck manufacturers had 5.8 per cent. Ninety-two printing and publishing firms recorded a return on sales of 6.2 per cent.

"The 99 petroleum companies? They enjoyed a return on sales of 9.0 per cent. Only the drug industry scored higher, with 42 drug makers reporting a return on sales of 9.5 per cent.

"The oil industry, however, does not place as much importance on these figures as it does on those that reflect its rate of return on investment. And, indeed, the First National City Bank reports that the average rate of return on net worth for the 2,250 companies surveyed was 13.1 per cent in 1968, up from 12.6 per cent in 1967. The 99 oil companies, however, had a return on net worth in 1968 of 12.9 per cent, compared with 12.8 per cent in 1968. So in terms of return on investment, the oil industry is slightly below the national average.

"Some oilmen, moreover, say the difference is greater than it seems because the figures do not reflect what it actually costs to replace extracted oil.

" 'If oil companies figured in what it is costing them to replace their oil, it could cut their return on investment by one-half,' declares Minor Jameson, Jr., executive vice president of the Independent Petroleum Association of America.

"It is at this point that the debate over preferential tax treatment for the oil industry approaches the heart of the matter. Most independent economists have a ready answer for Mr. Jameson.

"Prof. Walter J. Mead, professor of economics at the University of California, Santa Barbara, told the Senate subcommittee in March of this year:

" 'The effect of favored tax treatment is to reduce tax costs for oil companies relative to firms in other industries. These measures taken together substantially raise the expected after-tax profit rates on oil industry exploration and development investments in what would otherwise be submarginal uses of scarce capital. Investment in petroleum exploration and development is indeed expanded to the point where the after-tax return is approximately equal to that which may be obtained on alternative uses of capital.* * *

" 'Oil industry spokesmen have defended their various subsidies with the question, "If we receive all the subsidies which our critics allege, why is our rate of return on invested capital not substantially righer than other nonsubsidized industries?" The answer to this question is that a subsidy will raise the profit rate at the point in time at which it is conferred.

" 'Its effects, however, are eroded away with time as producers react to their more profitable situation by expanding into otherwise submarginal areas. This expansion leads to a decline in the rate of return toward a normal yield and to resource misallocation as well.'

"And here Professor Mead adds an interesting observation in the light of the industry's particularly visible troubles earlier this year.

" 'The oil spillage case in the Santa Barbara Channel is directly related to the subsidy system. Leases were purchased and drilling occurred in the California offshore area because such operations were made profitable by the subsidy legislation. Under free market conditions, oil prices would be substantially lower, tax costs substantially higher in the oil industry, and the profit inducements to buy leases in the Channel would probably be lacking.

" 'To develop oil from such sources is to use up more economic value than is produced. In addition to this probable waste of resources, we have the external cost (aptly called "spillover costs" even before this oil spillage case) of environmental pollution.'

"Oil industry spokesmen speak frequently about domestic taxes paid as a percentage of gross revenue. The Petroleum Industry Research Foundation, for example, recently published a report showing that the industry paid 5.1 cents on each dollar of gross revenue in 1964 and 1965. This includes Federal, state, and local taxes, but *excludes* state and Federal product taxes. The study showed all business corporations paid an average of 4.5 cents on each dollar of gross revenue.

"THE ACCENT ON GROSS

"So, set forth in these terms, the oil industry pays six-tenths of a cent per gross-revenue dollar more than the average of all industries.

"But the comparison is in gross revenue, and does not take into consideration the cost of doing business. Thus if a company doing $10 billion a year volume had business costs of $9 billion, it would probably pay less in taxes than a $10 billion-a-year business with costs of $5 billion. The oil industry's ratio of expenses to gross revenue is lower than that of many other industries.

"The oil industry contends that in 1966 it was responsible for $10.5 billion in taxes. Testifying before the House Ways and Means Committee, M. A. Wright, chairman of Humble Oil, a subsidiary of Jersey Standard, declared:

" 'Aggregate tax payments on oil industry operations in 1966 were $10.5 billion, including $8 billion of excise and sales taxes on oil products. These payments provided 5 per cent of all receipts of the Federal, state, and local governments.'

"But that $8 billion Mr. Wright refers to was not paid by the oil companies. It was paid by, among other customers, the motorists who buy gasoline at the industry's thousands of filling stations.

"Now consider data from the Treasury's tax-reform study, which shows 'estimates of the effective tax rates actually paid by corporations, as a group and for several industries.' Here are the 1965 figures on 'actual (Federal) tax on total net income:'

"[In percent]

"All industries	37.5
"Petroleum	21.1
"Other mineral industries	24.3
"Lumber	29.5
"Commercial banks	24.4
"Other manufacturing	43.3

"Only mutual savings banks (5.3 per cent) and savings and loan associations (14.5 per cent), among the categories considered, had lower effective tax rates than the oil industry.

"Oilmen contend the price of gasoline has been remarkably stable in a period of general inflation. But, according to the Oil and Gas Journal of April 14, 1969, the average price of regular gasoline—excluding taxes—has increased 7.4 per cent since April 1968, and 5.9 per cent since the last week in December 1968.

"Its many tax privileges give the oil industry tremendous cash flows and thus very great financial leverage. Some critics argue that this gives oil an unfair advantage over competing industries. But the industry insists the nature of its business requires that heavy cash flow.

"'It is essential because so much of our investment is such high risk that it isn't bankable,' says John J. Scott, general counsel of Mobil Oil. Mr. Scott cited as an example Mobil's operations in Venezuela. Prior to and during World War II, Mobil invested between $45,000,000 and $50,000,000 in that country before getting any return on its investment. 'If we did not have the cash flow, we could not have done it,' Mr. Scott says.

"What would happen to the industry's oil reserves if the depletion allowance and deductions for intangibles were eliminated?

"Frank N. Ikard, president of the American Petroleum Institute, offers this reply:

"'I can tell you one thing that is spectacular: The size of the investment in exploration and development the industry is going to have to make to meet the needs of the American people over the next 15 years. As a rough estimate, domestic oil exploration and development outlays will have to be increased about 50 per cent. This means going from a little less than $4.5 billion annually up to somewhere around $6 or $7 billion. An industry that has to make such a big boost in its spending has to make profits to do its job.'

"Some industry sources say oil needs more tax breaks, not less. Harold M. McClure, Jr., president of the Independent Petroleum Association of America, cited figures before the House Ways and Means Committee that showed a 40 per cent reduction in the number of wildcat test wells drilled in 1968 compared with the number drilled in 1956.

"'It should be recognized,' said Mr. McClure, 'that part of these decreases can be attributed to wider well spacing and increased efficiencies in all phases of drilling and producing operations.'

"It's interesting that Mr. McClure should use the year 1956 as a comparative figure for 1968 drilling operations. Says the CONSAD report: 'The number of wells being drilled reached a peak in 1955–56, but has since declined steadily back to its 1949 level, over 30 per cent below the peak.'

"Mr. McClure told the senators further: 'To re-emphasize the degree of risk, only 2 out of every 100 new field wildcats drilled are likely to find a field large enough to be profitable. * * * To sum up the situation as to incentives for petroleum exploration and development in the United States, there is an obvious need for more—not less—economic stimuli.' A wildcat is an experimental or exploratory well.

"Mr. McClure uses the term 'economic stimuli.' In the oil business there are stimuli within stimuli. It is not only the major tax privileges themselves that benefit the industry; it is also the accounting involutions that they make possible. A good example of such an involution can be found in the uses to which the depletion allowance is put.

"Simply stated, oil companies shift expenses, for tax purposes, to the wellhead, where depletion may be claimed, from refinery or transportation costs that do not qualify for this deduction.

"In a Senate speech recently, Sen. William Proxmire, Wisconsin Democrat and critic of oil-industry privileges, described the answers he received from the Interior Department to questions he had posed:

"'Apparently,' said Senator Proxmire, 'Interior had made an analysis which demonstrates that integrated companies shift income from refining and marketing to oil production in order to minimize tax liabilities by maximizing percentage depletion. This analysis is correct as was shown by Texaco's recent action in increasing the price it would pay for crude oil by 20 cents a barrel.

"'Since Texaco produces most of the crude oil it refines, the increased cost on the 11,000 net barrels a day it buys from outsiders will be more than offset by the larger depletion allowances it will claim on the oil which it sells to itself. Apparently, Texaco felt the 1.9 per cent of its income paid in Federal income taxes in 1967 was too high.'

"While Senator Proxmire singled out Texaco as an example, that company is hardly alone in taking advantage of the tax laws as they are on the books.

"One of the laws on the books permits oil companies to deduct from their U.S. tax obligation the income taxes they pay to foreign governments. To get as much revenue as possible from the oil companies, oil nations in the Middle East and elsewhere base their tax schedule on 'posted price,' which are set arbitrarily and are almost always higher than the actual price the companies get for their oil.

"The result is that American companies must pay foreign governments more in taxes than they would if the taxes were figured on the true price for which oil can be sold. Thus, a portion of the foreign tax is considered by many critics as not a tax but a royalty. Therefore, so the argument goes, U.S. companies should be permitted to deduct from their U.S. taxes only that part of foreign taxes that are truly taxes. The other part, which would be considered as royalties, would then be figured as just another business expense.

"The oil companies, who are being overcharged by foreign governments, don't like the system of posted prices any more than the U.S. Treasury Department does, but they say there's nothing they can do about it.

"The House Ways and Means Committee has about two dozen bills of various sorts that deal with reforming the tax structure as it affects oil. One House bill would eliminate entirely the depletion allowance as it relates to foreign wells; Maine's Edmund Muskie has introduced a similar bill.

"Rep. Henry Reuss, Wisconsin Democrat, has introduced a major tax reform package, one section of which would drop oil and gas depletion allowances, presently 27.5 per cent, and allowances for 41 other minerals, presently at 23 per-cent, down to 15 per cent.

"In introducing his bill on Jan. 29 of this year, Mr. Reuss told the House: 'Ideally, percentage depletion should be replaced with cost depletion. But since we are not living in an ideal world, this title provides only that the oil depletion allowance be reduced by less than one-half, from 27.5 per cent to 15 per cent, the percentage now applicable to over 40 other minerals.'

Mr. Reuss and his supporters are not overly optimistic about changing oil's depletion allowance, especially now that President Nixon has reiterated his support of the allowance as it stands.

"Nevertheless, says Mr. Reuss, 'There is a general sentiment among taxpayers that they are getting a little depleted too.'

"In the American system of making law, it is far easier to establish prerogatives than to abolish or reduce them. To the beneficiary, preferential treatment becomes first a comfort, then a custom, and finally a necessity. And the progression can be carried still one step further. What of the nation's best interests? The late Sam Rayburn wasn't the only friend of oil to know when to turn solemnly and face the American flag.

THE DEPLETION ALLOWANCE

The 27.5 per cent depletion allowance for oil and natural gas is probably the best known of all business tax exemptions. Here's how it came to be:

"The Sixteenth Amendment, which became effective on March 1, 1913, made it legal for Congress to assess income taxes. The Revenue Act passed on Oct. 3, 1913, provided that in computing income subject to taxation, producers of ores and all other natural deposits could claim a depletion deduction not to exceed 5 per cent of the gross value of the output at the mine or well.

"In 1916 the law was changed, removing the limitation, but specifying that the total depletion allowable over the life of the property could not exceed the capital originally invested, or, if the purchase of the property was made before March 1, 1913, the fair market value as of that date.

"A second provision was introduced in 1918 allowing 'discovery value depletion.' The estimated discovery value was substituted as the value to be amortized for all wells found after March 1, 1913. It wasn't until 1926 that discovery value depletion was replaced by today's system of percentage depletion for oil and natural gas.

"Under the 1926 law, any oil or gas producer, or anyone with a financial interest in a well, can deduct 27.5 per cent of his gross income realized from the sale of oil or gas, but this must not exceed 50 percent of the net income of the property.

"Why 27.5 per cent? Because the House of Representatives wanted the figure to be 25 per cent and Senate wanted 30 per cent. The 27.5 per cent figure for oil and gas is the highest depletion allowance; other minerals receive smaller allowances. Metals, for instance, qualify for 15 per cent.

"The U.S. Treasury Department reports that, on an average, petroleum producers recover 19 times the cost of their producing wells through percentage depletion."

THE TAXES COMPANIES PAY—FEDERAL CORPORATE INCOME-TAX PAYMENTS FOR 1967 OF THE NATION'S 15 LARGEST OIL REFINERS

Name	Net income before tax	Federal tax	Percent	Earnings after all taxes
Standard (New Jersey)	$2,098,283,000	$166,000,000	7.9	$1,232,283,000
Gulf	955,968,000	74,142,000	7.8	578,287,000
Texaco	892,986,000	17,500,000	1.9	754,386,000
Mobil	594,593,000	26,900,000	4.5	385,393,000
Standard (California)	513,067,000	6,000,000	1.2	421,667,000
Standard (Indiana)	366,847,000	74,021,000	20.2	282,250,000
Shell	342,022,000	44,940,000	13.1	284,849,000
Phillips	227,766,000	52,255,000	22.9	164,015,000
Conoco	241,362,000	30,031,000	12.4	148,962,000
Cities Service	165,289,000	32,347,000	19.6	127,837,000
Union	163,820,000	10,400,000	6.3	144,963,000
Sun	146,946,000	24,700,000	16.8	108,576,000
Atlantic	145,259,000	(1)	0.0	130,005,000
Marathon	138,520,000	3,700,000	2.7	73,858,000
Getty	132,762,000	3,687,000	2.8	118,166,000
Total	7,125,490,000	566,623,000	8.0	4,955,497,000

[1] None.

Source: Oil Week.

[From the Washington (D.C.) Post, June 9, 1969]

OIL INDUSTRY LASHES BACK AT CRITICS

(By Spencer Rich)

"The oil industry, under sharp attack by economists before a Senate subcommittee for a system of subsidies that may cost the public anywhere from $2.7 billion to $7 billion a year, got in some whacks of its own at hearings over recent weeks.

"But the industry failed to answer several of the most damaging charges leveled by earlier witnesses. Its case for continuation of at least some lush benefits must be rated as plausible but not quite convincing.

"The basic outlines of the dispute are well known by now. The industry enjoys a number of tax benefits—including a depletion allowance and the overseas tax credit—that are available in equal measure to no other industry.

"The net benefit to the industry in taxes saved as a result of these special provisions may be as much as $2 billion a year.

"In addition, an import quota system started in 1959 limits total annual imports to about one-fifth of the 5 billion barrels of oil consumed in this country annually.

"More important, it keeps low-cost Middle Eastern crude oil, which could be sold at $2 a barrel delivered to the Eastern Seaboard, out of the country except in quota amounts.

"Together with production limitations imposed by the states of Texas and Louisiana, which produce three-quarters of U.S. oil, the import system keeps the domestic price of oil delivered to the East Coast at nearly $3.50 a barrel—or about $1.50 more a barrel than the potential price of imported oil.

"Economists estimated that as a result of this differential, the public pays anywhere from $2.7 billion to $7.2 billion more for its oil than would be the case if the world price of oil were in effect in the U.S.

"Industry witnesses—including Harold McClure of the Independent Petroleum Assn., which represents smaller domestic operators, M. A. Wright of Humble Oil (Standard of New Jersey's operating subsidiary in this country) and Robert Dunlap of Sun Oil—justified this system as necessary to maintain U.S. national security.

"Without the financial incentives provided by tax breaks and import barriers, they said, U.S. discovery and development of new domestic oil reserves would fall off and the U.S. would soon be dependent upon foreign nations for an unacceptably large portion of its supplies. This would make it vulnerable to diplomatic blackmail, they contended.

"Wright of Humble estimated that with continued import barriers, relaxed slightly to allow more foreign oil in as U.S. needs increased this Nation would be able to supply 82 percent of its needs from domestic sources by 1985. With import controls removed, he said, the figure would drop to 46 percent, which he said was too low for national security.

"Sen. Philip A. Hart, (D–Mich.), who presided over the hearings as chairman of the Senate Antitrust Subcommittee, kept digging into this argument at different vulnerable spots, as did some of his staff members. By the time the latest innings were over, he had succeeded in considerably reducing its cogency.

"For example, Hart kept going back to the potential of the nation's huge known reserves of oil shale, which contain at least 600 billion barrels of potentially recoverable oil—over 100 years' supply. The shale, located mainly in Colorado, cannot now be converted into oil at a commercial price and for this reason industry spokesmen pooh-poohed it as a possible national security reserve.

"But they did not really answer the point Hart seemed to be making: the shale is there and if we knew how to convert it we could save a substantial amount of spending on new exploration for well oil. Why not allow much more imported oil into the country, save a few billion dollars a year and devote a portion of that to cracking the problem of making the shale convertible into oil at a competitive price?

"Interior Secretary Walter J. Hickel has estimated it would cost $1 billion to achieve a research and development breakthrough on shale. But even if it cost five times that figure, it would still be equal to only a single year's added costs resulting from oil import barriers. The same argument goes for efforts to convert the Nation's massive coal reserves to oil and gas. The Interior Department is spending only $13 million this year on research on shale and coal liquefaction and gasification.

"Hale and his chief economist, Dr. John Blair, also kept bringing up the problem of tax incentives to domestic exploration, and the industry never answered.

"If the purpose of the whole system of tax breaks and import barriers is to provide U.S. companies with incentives to devote money to exploring for oil here, then why keep in existence tax benefits that encourage money to be diverted into overseas discovery?

"About 25 per cent of depletion allowances claimed by U.S. companies covers overseas holdings. In addition, U.S. law permits oil companies to subtract—dollar for dollar—from their U.S. taxes any taxes paid to foreign governments.

"Royalities can only be deducted from taxable income, but taxes can be taken directly off the tax bill in the full amount paid.

"One apparent result is that a very high proportion of total charges to U.S. companies by foreign governments are classified as 'taxes' by those governments, while a much smaller portion are called royalties.

"Another unanswered question is just how much security the U.S. is actually buying. Nobody seemed to have any hard figures—worked out on a gallons a day basis for various activities—on how much oil the U.S. really needs to protect its welfare. Must it really be 80 per cent? Or could it be less?

"Industry witnesses conceded that at present rates of discovery and increasing demand, the U.S. will be increasing its imports over the next generation anyhow. The inference of industry critics was obvious—why not increase them a little faster and save all that money by getting a bit more low cost foreign crude now?

"The exact character of the national security problem was also a little vague. Wright of Humble appeared to concede at one point that it was not really possible to insist that domestic production remain high in order to plan for nuclear war.

"That kind of situation would alter conditions so radically that normal calculations of oil need would probably be meaningless.

"But then, Sen. Edward M. Kennedy (D–Mass.) indicated, it would be a whole new ball game. In anything short of an all-out war, he argued, at least some U.S. supplies from abroad would be available: from Canada, Venezuela and Caribbean nations, which now supply the U.S. with nearly all its imports; or from one of the many new producers whose desperate race for markets is flooding the world with oil and causing what appears to be a long-term downtrend in oil prices everywhere but in the United States.

"The Hart hearings are now recessed and the dispute is moving to a new arena. In about a week and a half, the Cabinet Committee on Oil Imports, headed by Labor Secretary George P. Schultz, will begin receiving documents arguing for and against the present import program. It is to come up with recommendations on the future of the program in six months."

Mr. PROXMIRE. Mr. President, I suggest the absence of a quorum.

[H.R. 13270, 91st Cong., 1st sess.]

IN THE SENATE OF THE UNITED STATES

Referred to the Committee on Finance and ordered to be printed
Order to lie on the table and to be printed

Amendment intended to be proposed by Mr. PROXMIRE, BROOKE, KENNEDY, MCGOVERN, MCINTYRE, MONDALE, MUSKIE, NELSON, PELL, and STEPHEN YOUNG to H.R. 13270, an Act to reform the income tax laws, viz: On page 273, line 13, strike all through line 18, page 273 and insert the following:

SEC. . PERCENTAGE DEPLETION RATES FOR OIL AND GAS WELLS.

(a) GRADUATED RATES FOR DOMESTIC WELLS.—Section 613 (relating to percentage depletion) is amended—

(1) by striking out in subsection (a) "Specified in subsection (b)" and inserting in lieu thereof "specified in subsections (b) and (d)";

(2) by striking out paragraph (1) of subsection (b) and inserting in lieu thereof the following:

"(1) DOMESTIC OIL AND GAS WELLS.—The percentage applicable under subsection (d)(1)."; and

(3) by striking out subsection (d), and by inserting after subsection (c) the following new subsections:

"(d) OIL AND GAS WELLS LOCATED IN UNITED STATES.—

"(1) PERCENTAGE DEPLETION RATES.—In the case of domestic oil and gas wells, the percentage referred to in subsection (a) is as follows:

"(A) 27½ percent—to the extent that, for the taxable year, the taxpayer's gross income from the property, when added to (i) the taxpayer's gross income from all other domestic oil and gas well properties, and (ii) the gross income from domestic oil and gas well properties of any taxpayer which controls the taxpayer and of all taxpayers controlled by or under common control with the taxpayer, does not exceed $5,000,000:

"(B) 21 percent—to the extent that, for the taxable year, the taxpayer's gross income from the property, when added to (i) the taxpayer's gross income from all other domestic oil and gas well properties, and (ii) the gross income from domestic oil and gas well properties of any taxpayer which controls the taxpayer and of all taxpayers controlled by or under common control with the taxpayer, exceeds $5,000,000 but does not exceed $10,000,000; and

"(C) 15 percent—to the extent that, for the taxable year, the taxpayer's gross income from the property, when added to (i) the taxpayer's gross income from all other domestic oil and gas well properties, and (ii) the gross income from domestic oil and gas well properties of any taxpayer which controls the taxpayer and of all taxpayers controlled by or under common control with the taxpayer, exceeds $10,000,000.

"(2) DOMESTIC OIL AND GAS WELLS.—For purposes of this section, the term 'domestic oil and gas well' means an oil or gas well located on property in the United States or on the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act).

"(3) CONTROL DEFINED.—For purposes of paragraph (1), the term 'control' means—

"(A) with respect to any corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or the power (from whatever source derived and by whatever means exercised) to elect a majority of the board of directors, and

"(B) with respect to any taxpayer, the power (from whatever source derived and by whatever means exercised) to select the management or determine the business policies of the taxpayer.

"(4) CONSTRUCTIVE OWNERSHIP OF STOCK.—The provisions of section 318(a) (relating to constructive ownership of stock) shall apply in determining the ownership of stock for purposes of paragraph (3).

"(5) APPLICATION UNDER REGULATIONS.—This subsection shall be applied under regulations prescribed by the Secretary or his delegate.

"(e) OIL AND GAS WELLS LOCATED OUTSIDE THE UNITED STATES.—In the case of oil and gas wells, other than domestic oil and gas wells, the allowance for depletion under section 611 shall be determined without reference to this section."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. . ROYALTIES PAID IN FORM OF FOREIGN TAXES.

(a) DENIAL OF TREATMENT AS TAXES.—Section 903 (relating to taxes in lieu of income, etc., taxes) is amended by striking out the period at the end thereof and inserting in lieu thereof the following: ", but such term does not include any amount paid (whether or not denominated or imposed as a tax) to any foreign country or possession of the United States which—

(1) is determined on the basis of the ownership of oil and gas or oil and gas rights by the government of such foreign country or possession, or is otherwise in the nature of a royalty payment, or

(2) is determined on the basis of a constructive or artificial selling price of minerals or mineral products."

(3) Any foreign "tax" as aforesaid or any foreign tax in excess of U.S. taxes on oil and gas properties shall be deemed to be an ordinary and necessary business expense within the meaning of section 162.

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after the date of the enactment of this Act.

KANSAS INDEPENDENT OIL & GAS ASSOCIATION,
Wichita, Kans., October 6, 1969.

WILLIAM PROXMIRE,
New Senate Office Building,
Washington, D.C.

MY DEAR SENATOR: Prior to the hearing before the Senate Finance Committee, we were assured that at least one committee member would inquire why this association had voted so strongly to support your proposed amendment relative to the mineral tax provisions of H.R. 13270. Knowing that our time to testify was going to be so severely delimited, we determined to omit this statement from our formal statement and rely on questions to elicit the information.

Be assured that there is no question about our support for the amendment. We enclose a copy of our formally adopted resolution with respect thereto. Further, we enclose a statement which sets forth our rationale in supporting your amendment.

Respectfully,

V. RICHARD HOOVER.

"We recognize the imperative necessity for tax reform. The oil industry must bear a portion of the cost of this reform. The Proxmire amendment provides tax reform. It reduces both foreign and domestic depletion and eliminates foreign tax credits when they are nothing more than royalty payments. Other sections of the bill have similar merit. To those who are critical of the sliding scale depletion as being discriminatory, we submit that it is compatible with the established theory of the graduated income tax."

RESOLUTION

Whereas, the United States House of Representatives has passed by a vote of 394–30 and sent to the U.S. Senate a "tax reform" bill, some major provisions of which adversely affect established mineral tax policy; and

Whereas, said bill will be referred to the Committee on Finance, where extended hearings will be held, commencing September 4, 1969; and

Whereas, many amendments to the House version of the bill are being suggested, many of which are even more adverse in their effect upon the domestic petroleum industry; and

Whereas, Senator William Proxmire (D-Wisc.) has prepared an amendment to said "tax reform" bill under the number & style of an amendment to H.R. 12290, the terms of which contain reasonal provisions for the small domestic independent operator and producer and that said amendment will be offered in the Senate Finance Committee or upon the floor of the United States Senate; and

Whereas, it is very much to the interest of the State of Kansas, its citizens and the independent petroleum industry to maintain a reasonable tax climate for the exploration and development of the state's petroleum resources; and

Whereas, it is the desire of the Kansas Independent Oil and Gas Association, which represents nearly 1300 small independent producers and drillers in Kansas, to endorse and support this amendment and its provisions.

Now Therefore be it Resolved by the Board of Directors of the Kansas Independent Oil and Gas Association, the same being duly vested with the authority to establish association policy, in meeting assembled this 2nd day of September, 1969, at Wichita, Kansas, that the Association endorses and pledges its full support for the incorporation of the provisions of the Proxmire amendment into any "tax reform" bill ultimately passed by the Congress.

Be it Further Resolved, that an executed copy of this resolution be furnished to Senator Proxmire, forthwith.

TOM L. SCHWINN,
Executive Vice-President.

Attest:

ROBERT L. WILLIAMS, Jr., *Secretary.*

The CHAIRMAN. The next witness is Senator Allott of Colorado.

I am informed that Senator Allott is necessarily detained and that he will be along as soon as he can.

We will call the next witness, Mr. Fred W. Peel, chairman of the American Mining Congress Tax Committee. Mr. Peel, we are glad to welcome you back. We know of the good work you did for us years ago when you were a member of the staff of the Finance Committee and later when you served on the staff of the Joint Committee.

STATEMENT OF FRED W. PEEL, CHAIRMAN OF THE AMERICAN MINING CONGRESS TAX COMMITTEE; ACCOMPANIED BY LAURENCE P. SHERFY, GENERAL COUNSEL

Mr. PEEL. My name is Fred Peel, chairman of the Mining Congress Tax Committee, and I am accompanied by Mr. Laurence P. Sherfy who is general counsel of the Mining Congress.

I am here today to present the position of the American Mining Congress on those provisions of the tax bill that are of particular concern to the mining industry.

I would like to focus first on the depletion rates. To consider these, we believe that you should take into account the problems in the past that the depletion provisions were designed to solve, the extent to which the provisions of the present law have become an integral part of the basic economic structure of the industry, and the role percentage depletion can be expected to perform in the future.

Looking at the history, the Corporate Excise Tax Act of 1909 first taxed mining income, and taxpayers contended that they should not be taxed on this as ordinary income because they were disposing of capital assets. The Supreme Court held against them on that point, however, and said that the profits were taxable as ordinary income, notwithstanding the fact that the minerals could not be replaced as manufactured inventory could be replaced.

Those decisions by the Supreme Court set the stage for the subsequent problems which Congress still has to struggle with, of fitting the disposition of irreplaceable mineral deposits into an income tax system that is designed primarily to tax profits on replaceable items.

The Revenue Act of 1918 first allowed discovery depletion. The depletion allowance was based on the fair market value of the property at the date of discovery or within 30 days thereafter. This discovery depletion was the forerunner of the present percentage depletion provisions of the income tax law. Percentage depletion first came in in the Revenue Act of 1926, applying to oil and gas.

In the Revenue Act of 1932 it was first applied to the hard minerals. It was applied to metal mines, to sulfur, and to coal at varying rates. Discovery value depletion was no longer allowed for those minerals that were allowed percentage depletion.

The Revenue Act of 1942 extended depletion to certain other minerals. Further extensions were made in the 1943 act. Some of these were allowed only for the period of World War II. In 1947 these wartime depletion allowances were made permanent, and certain other minerals were added to the list. In the Revenue Act of 1951, about 30 additional nonmetallic minerals were added to the list at depletion rates varying from 5 to 15 percent.

Then in 1954 virtually all minerals were granted depletion at rates varying from 5 to 23 percent, except for soil, sod, dirt, turf, water, mosses, minerals from the sea water, the air, or similar inexhaustible sources.

The depletion provisions have on a number of occasions been reviewed by Congress, and they have survived constant attack. There were two full-scale efforts by the Treasury Department to eliminate or reduce the benefits of these provisions. These were in 1942 and again in 1951.

On each occasion the Treasury's recommendations were rejected, and actually percentage depletion allowances were extended by Congress at those times to additional minerals.

To summarize, the present percentage depletion provisions are traceable to the very beginning of our Federal income tax. They are a part of our fundamental tax structure, and they have a sound economic justification. There are good reasons for Congress' enactment of those provisions. Furthermore, percentage depletion has now become an integral part of the economics of one of our most important industries.

There are over 15,000 mines in this country today. In 1967 they produced products with a value of $10 billion. They employed 350,000 production workers.

For the future, the Bureau of Mines has predicted that mineral demand in this country by the year 2000 will be four times what it is today. They project a fivefold increase in demand worldwide. Yet based on their projection of the present rate of production domestically our domestic production of minerals is only going to just about double by the year 2000.

In the face of this increased gap between domestic production and domestic demand, we will, of course, have to rely more and more on mineral imports.

In view of the particularly long leadtime in the mineral industry, in exploring for, developing, and getting into production on mines, projection of increasing gaps between demand and production should be of serious concern to Congress.

For most minerals the tremendous future demand can be handled by a four-pronged approach. First, more intensive and extensive exploration. Second, mining lower grade ore deposits. Third, more research in mineral recovery and mining methods. Fourth, more intensive investment input in mechanized facilities. All four of these approaches require more capital, much more capital.

We will over the next 30 years necessarily have to go to the less desirable deposits because the easily discovered, rich deposits have been or are being rapidly mined out.

All of this points toward increased mechanization, increased use of large-scale equipment, and this means heavier and heavier capital investment.

According to the most recent Fortune magazine survey of the 500 largest corporations, mining companies included in that survey had capital assets of $134,000 per employee, by far the largest investment per employee of any category.

Furthermore, additional costs have been imposed on the mining industry in connection with pollution control, mine reclamation, and mine safety. All this adds up to a great problem of finding the money to meet the future mineral demands of the country.

The decisive point is the rate of return after income taxes on the funds that must be tied up in these long-range mining projects. If depletion deductions are cut, some of these projects simply will not pass the test of an acceptable after-tax rate of return at present price levels.

In the long run failure to develop new sources would cut mineral supply. The effect would be to slow down the development of the whole economy, and by imposing higher costs for minerals, would eventually result in passing on the additional tax burdens to the mineral consumers.

Consequently, we strongly urge that depletion rates applicable to the mining industry under present law be retained by this committee.

Turning now to some of the other provisions of the bill; with respect to effective dates, we suggest that all of the tax—imposing provisions of the bill be applied prospectively only. With respect to the amendments to the mining exploration provisions, sections 615 and 617, we suggest that taxpayers who elected section 615 in the past be given a new election—a new choice between section 615 and section 617, since the factors that led them to elect section 615 will no longer be present as that section is being amended.

We also urge that in writing up its report on these changes in the exploration provisions, the committee take this opportunity to make it unmistakably clear that expenditures after a mine reaches the development stage are not to be treated as exploration expenditures for tax purposes. We suggest that the committee state in its report on these mining exploration expenditure provisions that expenditures after the development stage is reached are to be treated as development—or production—expenditures, which we think was the intent when the present treatment of development expenditures was first enacted in 1951.

With respect to the provisions of the House bill affecting foreign mining, we suggest that any cuts in depletion rates on foreign deposits would be detrimental, not only to our mining industry, but to the conutry as a whole.

If our country discourages investment in foreign mining even for a short period of years, we will have to live with the consequences for generations.

We suggest that the entire subject of foreign tax credits and changes in depletion rates on foreign production from the domestic depletion rates be put over for consideration when the Treasury makes the comprehensive proposals that it has promised to this committee on the taxation of foreign income.

I think we should point out that the United States would gain virtually no revenue from denying or reducing percentage depletion on foreign mineral deposits.

With respect to the foreign tax credit provisions in the House bill, section 431 would require taxpayers using the per country limitation on the foreign tax credit to carry forward losses incurred in the Foreign country and use them to reduce income from that country in subsequent years before computing the limitations on the foreign tax credit. This is presented as an effort to eliminate a so-called double tax benefit, according to the report of the Ways and Means Committee, but this is not correct. There is no double benefit. In fact, the taxpayer who pays and claims a credit for foreign income taxes is not paying any less income taxes, United States and foreign, than a taxpayer with the same income and losses whose operations are all conducted in the United States.

This provision, if enacted, would be contrary to the principle of tax neutrality that is used to justify imposing U.S. tax on income from foreign sources. We suggest that if the Government is dissatisfied with the present lack of coordination between foreign taxes and U.S. taxes, that the proper approach would be to negotiate or attempt to negotiate tax treaties dealing with this problem with the various foreign countries rather than imposing a double burden on our taxpayers operating abroad.

Section 432 of the House bill would apply a separate limitation on the foreign tax credit with respect to all mining income from each country, if it meets one of three tests. These tests, according to the House committee report, are designed to isolate cases where it is likely that the income taxes represent at least in part royalties, but in fact these tests would have the effect of bringing virtually every foreign income tax on mining income within the scope of the provision.

The tests are that the foreign country requires payment of a bonus or royalty, holds substantial mineral rights with respect to the property, or imposes any income taxes on mining income at an effective rate higher than on other income. These three tests are treated as conclusive presumptions that the income taxes paid represent royalties to some extent. but they are at best flimsy reasons for even suspecting that the taxes represent royalties. The fact that royalty is paid, for example, is certainly not an indication that the tax paid is also a royalty.

We urge, that this attempt to fragment the foreign tax credit be eliminated from the bill.

The Treasury has opposed section 432 of the House bill, but they have suggested an alternative, which, while it would not be as onerous or as difficult to supply as section 432, would still be subject to serious objection. It is subject to the criticism that it attempts to segregate a specific category of income and compare U.S. and foreign income tax rates on it.

The Treasury proposal would say that, to the extent that an excess foreign tax credit is generated by the fact that for U.S. tax purposes the taxpayer has a depletion allowance, that the unused credit could not be used or applied against other income. While this has the appearance of precision, the appearance is illusory because neither the United States nor most foreign countries really impose taxes on categories of income in that systematic fashion.

If the approach suggested by the Treasury should be adopted the United States would be taking a step toward an infinitely more complex foreign tax credit system in which we would engage in a hopeless attempt to match foreign taxes against U.S. taxes on an item by item basis, for each item of income. Consequently we urge rejection of this Treasury alternative proposal as well as section 432 as it appears in the House bill.

In the Treasury statement there was some comment on the possibility of a 60-percent limit on creditable foreign taxes. The Treasury mentioned this, but then went on to say that they believed it would be preferable to deal with high foreign tax rates in a general context so they did not make a suggestion on the point.

It is difficult to understand why they found it necessary to even raise the point, but we certainly agree that it would be inappropriate to consider any such limitation on the foreign tax credit at this time.

In conclusion, the American mining industry has a vital role in the development and maintenance of our economy. It has performed that role well under our present tax system, and in the process the mining companies have not made after tax profits that are out of line with those of industry in general. With an expanding population and an expanding economy before us, the mining industry has an even bigger job to do. It would be the height of folly to set up tax barriers to block the accomplishment of that job by cutting back on the present tax treatment of the mining industry.

Thank you.

The CHAIRMAN. What is your reaction to Senator's Proxmire's suggestion that depletion allowances are a very inefficient way to discover new reserves?

Mr. PEEL. I think Senator Proxmire's suggestion that depletion allowances are a very inefficient way to discover new reserves was directed at the oil and gas industry, and we would not presume to answer for the oil and gas industry. I do not know whether Senator Proxmire would apply the same tests to the depletion allowances for the hard minerals as he does to the depletion allowances for oil and gas. The depletion allowances for hard minerals have, however, a much broader objective than merely stimulation of discovery of new reserves. The objective is to moderate the tax burdens on the mining industry so that it will be able to finance the whole operation of exploring for—and developing—mineral products. The depletion allowances for the hard minerals industry certainly would have to be judged as having been highly successful in leading to the discovery of new reserves—but I would like to emphasize that that is by no means the only objective of the depletion allowances. If Senator Proxmire has in mind some form of Government subsidy as a substitute for depletion allowances to encourage discovery of new reserves, in our opinion this would definitely not be as efficient as the present depletion allowances.

The CHAIRMAN. Would capital gains treatment, either for royalties or for production working interest be a better answer?

Mr. PEEL. Capital gains treatment is provided under the present law for the recipients of royalties on coal and domestically produced iron ore. This treatment is satisfactory, and we see no reason why it would not be satisfactory if applied to the recipients of royalties on other minerals so long as the royalty payments are excluded by the mine operators as they are under the present law, both with respect to coal and iron ore royalties and with respect to other royalties. It is difficult to answer the question as to whether capital gains treatment for production working interests would be a better answer without knowing more of the details of the proposal and in particular how the losses on loss mines would be treated.

The CHAIRMAN. Would it be a better way to collect income on foreign production merely by imposing a tariff on importation or by making companies bid for the tickets under quota arrangements?

Mr. PEEL. We do not think it would be better to collect tax on foreign production of hard minerals merely by imposing a tariff on importation or by making companies bid under quota arrangements. The mining companies would still be subject to income tax in the foreign countries, which in most countries approximates or exceeds their domestic income tax rate. In addition, either the companies or the U.S. consumers would have to bear the burden of the proposed tariff on imports. Furthermore, since many minerals are imported into this country and then processed into manufactured products that are sold abroad, a tariff of this sort would make our domestic manufacturers less competitive in foreign markets, and thus hamstring our balance of payments. A quota system would have the same consequences if the quotas were set in such small amounts as to create a price for the quota tickets. Some minerals such as manganese are not mined in this country to any appreciable extent, and a tariff or artificial import quota on these minerals would clearly be a burden on the U.S. consumers, and the U.S. exporters of manufactured products using these minerals. There are several mineral import taxes on the statute books at the present time, and I believe all or most of these have been suspended by Congress. In summary, we do not think that tariffs or quotas would be a fair substitute for the present system of taxing foreign mining income.

The CHAIRMAN. Thank you.

Senator CURTIS. What do you think the effect of the enactment of the House bill would be upon the mining industry?

Mr. PEEL. Enactment of the House Bill would affect the mining industry seriously in several respects. First, repeal of the investment credit would be a serious loss to the mining industry since it is a capital intensive industry and future development will require even more intensive use of capital equipment. Second, virtually all branches of the mining industry would be affected by the cuts in depletion rates in the House bill with respect to foreign mines and, with the exception of gold, silver, iron, copper, and oil shale, with respect to domestic mines. Third, the treatment of mineral production payments as loans—which the Mining Congress has not opposed—would drastically reduce the depletion deductions that have been taken in recent years—particularly by the higher cost mines that were not otherwise able to qualify for the percentage depletion deductions at the gross depletion rates. Fourth, the cutbacks in foreign tax credits under sections 431 and 432 of the House bill would subject the mining industry to burdensome double taxation—both U.S. income taxes and foreign income taxes—in many instances. Section 431 would undoubtedly reduce the number of new mines that will be developed in foreign countries. In addition, the mining industry would be affected by various other provisions of the bill that would affect business generally. The overall result would be decisions against developing new mines—particularly high-cost mines and mines requiring large capital investments and particularly foreign mines.

Senator CURTIS. Thank you, Mr. Peel.

Senator MILLER. Mr. Peel, could you give the committee an estimate of the impact on the consumer through possible increased costs resulting from the reductions in percentage depletion in the House bill?

Mr. PEEL. We do not believe it is possible to answer this question with precise figures. The mining industry covers a whole range of minerals with differing production problems and differing market conditions. In those cases where mineral producers treat income taxes as a cost on the same basis as other costs, it would be reasonable to expect that the increased taxes from the reductions of percentage depletion deductions as a result of the House bill would be passed on directly to the consumer in the form of increased prices. In the case of those mineral products whose prices would not be immediately affected by an increase in tax costs of U.S. producers, the ultimate effects tend to be substantially the same because the reduction in after-tax rate of return as a result of lower percentage depletion deductions would reduce the flow of investment into the industry. This, in turn, would reduce the mineral supply and the resultant competition for the smaller supply would drive prices up. There is strong evidence that the longrun effect of reductions in percentage depletion will increase consumer costs in the fact that, in the past, the after-tax rate of return on investment in the mining industry has not been higher than that of industry generally.

Senator MILLER. Thank you.

Mr. PEEL. Thank you.

(Mr. Peel's prepared statement follows:)

STATEMENT OF THE AMERICAN MINING CONGRESS, PRESENTED BY FRED W. PEEL, CHAIRMAN, TAX COMMITTEE

Mr. Chairman, my name is Fred W. Peel. I am the Chairman of the Tax Committee of the American Mining Congress and I appear before you today to present the position of the Mining Congress on the provisions of H.R. 13270 that are of particular concern to the mining industry.

The American Mining Congress is a trade assoication founded in 1897. Its membership is composed of (1) United States companies that produce and process a majority of the nation's ferrous and nonferrous metals, coal, and industrial and agricultural minerals, and (2) United States companies that manufacture mining equipment and supplies. Its headquarters are in Washington, D.C. It coordinates the efforts of the minning industry to present to the Federal Government its views on developing and maintaining a strong and healthy industry.

DEPLETION RATES

In the form in which it passed the House, H.R. 13270 would reduce the present percentage depletion rate for minerals now eligible for 23% to 17%, a 26.1% reduction; for most minerals now eligible for a 15% rate to 11%, a 26.6% reduction; for minerals now eligible for a 10% rate, a reduction to 7%, a 30% reduction; for clay, shale, and slate now eligible for a 7½% rate, a reduction to 5%, a 33⅓% reduction; and for sand, gravel, and other minerals now eligible for a 5% rate, a reduction to 4%, a 20% reduction.

The changes in percentage depletion rates made by the House bill should be considered in the light of (1) the problems of the past that the depletion provisions of the present law were designed to solve; (2) the extent to which the provisions of present law have become integral parts of the basic economic structure of the industry; and (3) the role percentage depletion can be expected to perform in the future.

History of taxation of the mining industry

When the Corporate Excise Tax Act of 1909 was enacted, mining companies contended that profits from mining operations were not subject to ordinary income tax because the miners were disposing of their capital assets—the mineral deposits being wasting, irreplaceable assets. The Supreme Court decided, however, that the profit was taxable as ordinary income, notwithstanding the fact that the minerals could not be replaced as manufactured inventory could. *Stratton's Independence v. Howbert*, 231 U.S. 399; *Von Baumback v. Sargent Land Co.*, 242 U.S. 503. These decisions set the stage for the subsequent problem of fitting the disposition of irreplaceable mineral deposits into an income tax system designed primarily to tax profits on replaceable items. The Supreme Court also held that mining companies were not entitled to depletion deductions under the 1909 Act since there was no provision in the Act for such a deduction.

Ever since the enactment of the first income tax law in 1913, the mining industry has been allowed a deduction for depletion. The Revenue Act of 1913 limited this deduction to 5 percent of the gross value at the mine of the minerals produced. The Revenue Act of 1916 abandoned the 5 percent of gross value limitation and allowed a reasonable allowance for depletion not to exceed the market value in the mine of the products. This Act also permitted the taxpayer to compute his depletion deduction on the basis of the cost of the property or its fair market value as of March 1, 1913, whichever was the greater.

The Revenue Act of 1918 continued the allowance of a depletion deduction based on cost or the March 1, 1913 value, but in addition provided also for discovery depletion with respect to mines "discovered by the taxpayer on or after March 1, 1913 and not acquired as a result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost." In such cases the depletion allowance was based upon the fair market value of the property at the date of discovery or within 30 days thereafter. Discovery value depletion was the forerunner of the present percentage depletion provisions of the income tax laws.

The Revenue Act of 1921 amended the discovery depletion provision to limit the depletion allowance based on discovery value to the net income from the property. The Revenue Act of 1924 further limited the depletion deduction based on discovery value to 50 percent of the net income from the property.

The Revenue Act of 1926 incorporated the concept of percentage depletion into the tax law for the first time. That Act substituted a percentage depletion deduction for oil and gas wells of 27½ percent of gross income from the property, limited to 50 percent of the net income from the property. This deduction was in lieu of discovery value depletion. The administration of the discovery depletion provisions had been difficult and complex. The Senate Committee on Finance recommended the percentage depletion approach "in the interest of simplicity and certainty." No change was made in this Act in the method of computing the depletion deduction in the case of the mining industry.

Apparently as a result of a "Preliminary Report on Depletion" prepared by the staff of the Joint Committee on Internal Revenue Taxation in 1929 that was critical of the application and results of discovery depletion, Congress extended percentage depletion to metal mines, sulphur, and coal mines at the respective rates of 15, 23, and 5 percent on the Revenue Act of 1932. Discovery value depletion was no longer allowed for those minerals. Mines other than those entitled to percentage depletion still had the choice between cost depletion and discovery value depletion.

There were no further changes in the depletion provisions until the Revenue Act of 1942 extended percentage depletion of fluorspar, rock asphalt, and ball and sagger clay at the 15 percent rate applicable to metal mines. The Revenue Act of 1943 also extended the percentage depletion provision to a new group of nonmetallic minerals at a 15 percent rate: flake graphite, vermiculite, potash, beryl, feldspar, mica, lepidolite, spodumene, talc, and barite. With the exception of potash, the extension of percentage depletion to these minerals was for the war period only. This Act also incorporated into the tax law for the first time a definition of "gross income from mining" on which the percentage depletion deduction was computed. This provision was an outgrowth of controversies between the mining industry and the Treasury Department over what operations were mining processes for depletion purposes.

In 1947 Congress made permanent the extension of percentage depletion to the nonmetallic minerals that had been granted percentage depletion in 1943 for the duration of the war and added the names of the following minerals to the list entitled to the 15 percent rate: china clay, bentonite, gilsonite, thenardite or sodium sulfate, trona, pyrophyllite, and bauxite.

In the Revenue Act of 1951 percentage depletion was applied to about 30 new nonmetallic minerals at rates varying from 5 to 15 percent. This Act also changed the tax treatment of both exploration and development expenditures.

When the Internal Revenue Code of 1954 was enacted, all minerals were granted percentage depletion at rates varying from 5 to 23 percent except soil, sod, dirt, turf, water, or mosses or minerals from sea water, the air, or similar inexhaustible sources. With the extension of percentage depletion to virtually all minerals, the discovery depletion provision was dropped completely.

In the 1954 Code and at times subsequent to its enactment, the percentage depletion rates for various minerals were increased. Except for the changes in the rates and except for an amendment clarifying the definition of "gross income from mining," there have been no substantial amendments to the depletion provisions applicable to the mining industry since the enactment of the 1954 Code.

Reviews of percentage depletion

The percentage depletion provisions have survived constant attack since they first became part of our tax laws. Full scale efforts by the Treasury Department to eliminate or reduce the benefits of these provisions were made in 1942 and again in 1950. On each occasion the Treasury's recommendations were rejected and percentage depletion allowances were extended to additional minerals.

The percentage depletion provisions were incorporated into the 1954 Code, which was the product of a thorough review of the whole income tax system. Finally, Congress rejected proposals made by the administration in 1963 that would have had the effect of lowering the depletion deductions of all of the mineral industries.

A discussion of the several previous reviews of these provisions would not be complete without reference to the recommendation made by the President's Materials Policy Commission, the so-called Paley Commission, in its June 1952 report. This report said:

"In short, the device of percentage depletion as an incentive to minerals exploration is not without its limitations. But no alternative method of taxation has come to the Commission's attention or could be devised by the Commission which, in its judgment, promises to overcome these limitations and still achieve the desired results, particularly not without seriously dislocating well established capital values and other arrangements in the industries concerned, with highly adverse effects on supply. Taking the practical situation as it finds it, the Commission believes that any radical alteration of the existing tax arrangements would be undesirable."

To summarize—the present percentage depletion provisions are traceable to the very beginning of the federal income tax. They are a part of our fundamental tax structure and have a sound economic justification. It is important that this background be understood by those aiming at percentage depletion as one of the targets for tax reform. Not only were there good reasons for Congress' enactment, but percentage depletion has become an integral part of the economics of one of our most important industries.

The mining industry today

In the year 1967, there were over 15,000 metallic, nonmetallic, and coal mines in the country. See Appendix A for a breakdown of metallic and nonmetallic mines by size and mineral. The mining industry produced tonnages in 1967 valued at over $10 billion with 350,000 production workers. Their wages and salaries in 1967 totaled almost $2.5 billion. The mining industry's contribution to the overall economy was well expressed by Hollis M. Dole, who, as Assistant Secretary—Mineral Resources, in the Department of Interior, testified before the Subcommittee on Minerals, Materials and Fuels of the Senate Interior Committee on July 9, 1969 that:

"U.S. minerals provide only some 3 percent of the Gross National Product. But this is only the beginning—it is only the point of an inverted pyramid which depicts our industrial economy resting upon a small but absolutely essential minerals base.

"The impact of that 3% GNP directly results in 40% of the GNP and indirectly accounts for nearly 75%.

"Let's look at it another way: if you were to select 100 men as representative of the work force directly dependent upon minerals production in the U.S., you would find that it requires only 3 of these men to mine the ore but it takes 14 to produce the metal and 83 to fabricate, distribute and sell the ultimate product. If we could get our 'man in the street' to appreciate some of these facts, we would be making a good start."

Future mineral requirements

The Bureau of Mines has predicted United States mineral demand to increase by more than 4 times by the year 2000, whereas domestic mineral production projected on the basis of 20-year trends can only be expected to little more than double by the end of the century. The Bureau of Mines is also predicting that there will be a fivefold increase in worldwide demand by the year 2000.

According to the latest Bureau of Census median projection, the population of the U.S. is expected to reach 320 million people by the year 2000. As the standard of living of the expanding population increases, so does the per capita consumption of minerals. These factors are expected to account for a doubling of mineral demand by 1985 and further expansion to more than 4 times present demand by 2000. This is not surprising since, over the past century while our population grew more than 400 percent, our minerals consumption grew more than 4,000 percent. By the year 2000 per capita demand for minerals in the U.S. is expected to rise from $150 per year to approximately $420.

The following table has been compiled from the Bureau of Mines projections of United States demand and production for some of the basic minerals in the years 1985 and 2000. Also included are the projected requirements for these same minerals by the rest of the world based upon a projected world population climb to 6½ billion by the year 2000 coupled with expectations of increased per capita consumption.

FUTURE MINERALS REQUIREMENTS AS PROJECTED BY U.S. BUREAU OF MINES FOR THE YEARS 1985 AND 2000

Mineral element	U.S. demand (projected requirements)			U.S. production (projected upon trend of last 20 yrs.)		Rest-of-world demand (projected requirements)		
	1967	1985	2000	1967	2000	1967	1985	2000
	In million short tons							
Aluminum	3.7	11.6	29.9	0.4	0.4	5.8	12.0	23.2
Copper	1.5	2.6	4.0	.9	2.1	4.0	8.5	11.8
Iron	85.7	118.0	144.0	54.8	38.0	298.9	573.0	807.0
Lead	.7	.8	1.1	.3	0	2.4	3.8	5.0
Magnesium	2.1	3.4	5.1	2.0	3.7	6.5	12.0	16.7
Manganese	1.2	1.8	2.4	.1	0	7.1	13.9	18.8
Phosphorus	3.8	6.4	10.5	5.4	8.8	7.6	21.3	36.0
Potassium	3.4	6.3	10.8	2.7	5.9	10.3	22.5	38.0
Sodium	17.3	32.7	60.4	16.5	28.6	35.4	66.2	102.0
Sulfur [1]	9.3	18.0	32.0	9.1	12.6	18.0	51.0	92.0
Uranium	.001	.05	.2	.001	[2] .049	.001	.08	.2
Zinc	1.3	2.4	3.5	.5	.3	4.0	6.0	8.6
	In million pounds							
Molybdenum	54.5	88.0	130.0	88.9	167.9	82.5	122.0	170.0
Nickel	364.9	470.0	550.0	29.2	87.4	614.0	850.0	1,000.0
Tungsten	13.9	34.4	64.2	9.3	13.5	52.5	96.1	126.5

[1] Millions of long tons.
[2] Based on AEC procurement only.

Source: Compiled from Bureau of Mines commodity statements, Jan. 31, 1969.

The predictions of increased consumption are understandable when one considers the increases that have already taken place. For example, 20 years ago the United States consumed 12 pounds of aluminum per capita; today U.S. consumption is approximately 41 pounds per capita. Over the same 20-year period, Japanese consumption of aluminum has increased from ½ pound to 15 pounds. Copper consumption in the developing foreign countries is increasing at about the same rate. If the rest of the world should increase its per capita consumption of copper by the year 2,000 to our present level, this would require annual production of 15 times the amount now needed.

Our primary concern is with future United States demand. The increasing gap between United States demand and domestic production, of course, will have to be supplied by imports. Pointing out the growing interdependence of domestic and foreign sources of supplies in what is becoming a world natural resources economy, Dr. Walter R. Hibbard, former Director of the Bureau of Mines, said in September of 1966:

"Experience indicates that in mineral-related areas about 60% of the investment flow abroad is to cover depreciation, with the remaining 40% going into expansion. In view of this ratio, it becomes clear that a high level of capital input must be maintained to avoid jeopardizing the total value of these foreign investments. Studies also indicate that the net return on foreign investments must remain close to recent levels. Only in this way can enough new capital be generated to sustain investment rates that can assure a continuing ability to meet expanding demands for products. . . .

"This problem is intensified and complicated by the shifting economic, political, and social patterns that accompany other changes in our world. . . .

"As with the United States, the appetite of West Europe and Japan for mineral raw materials has outrun the capacities of economically viable indigenous resources. . . .

"Today, virtually every industrialized country is actively searching the world for mineral resources that can be developed to help supply their home demands."

In view of the particularly long lead-time in the mining industry, the projections of increasing gaps between demand and production are of serious concern. Lead-time is particularly important in the search for and development of foreign mineral deposits. Should the Congress, upon review in a few years of any additional tax burdens placed on U.S. mining abroad, decide that the additional taxes were a mistake, the opportunities which arose in the interim will have been lost forever, and the U.S. as a nation will become increasingly reliant on foreign-controlled sources of raw materials.

As the report of the Paley Commission made clear in 1952, the problem of meeting future demand for minerals is not one of the existence or nonexistence of mineral resources. Instead, the problem is whether the United States might find itself priced out of world markets for minerals or be forced to rely on less desirable sources. The one meaningful criterion is the cost of producing a unit of a given mineral. This criterion is central to consideration of the tax treatment of the mining industry today, because the tax treatment cannot be considered in a vacuum; taxes are not the only cost increase the mining industry faces. Increasingly, the industry will meet federal, state, and local pollution control, health and safety requirements, increasing acquisition costs—in addition to higher taxes—all at a time when it must somehow find ways of profitably extracting the lower-grade deposits that remain.

Tax treatment and the future

For most minerals the tremendous future demands will be handled by a four-pronged approach:

1. More extensive (and intensive) exploration;
2. Mining lower-grade ore deposits;
3. More research in mineral recovery methods and mining methods; and
4. More intensive investment input in mechanized facilities.

All four of these solutions require more capital—much more capital. As far as the accessible areas of the world are concerned, the deposits that reveal themselves with surface outcrops have already been discovered. Today a minerals exploration program usually starts with aerial photos and may continue with geochemical surveys, aeromagnetic surveys, electromagnetic surveys, ground magnetometer surveys, induced polarization, gravity surveys, and, eventually, diamond drilling or trenching. All of this adds up to tremendous expenditures. Furthermore, these exploration techniques have by no means eliminated the risk that the exploration will be unsuccessful. The process is risky as well as costly.

Mineral deposits are irreplaceable and, by and large, the best ones go first. Thus, as we attempt to meet the increased demand over the next 30 years, we will necessarily be forced to go to less desirable deposits—that is, those with a lower percentage of mineral content, those that are more difficult to extract because of a higher ratio of overburden to the mineral, and those that are less accessible and more distant from markets.

Research and experimentation in methods of improving the efficiency of the recovery of desired minerals from crude ores and the improvement of mining techniques have helped the mining industry to maintain production even though the richer mineral deposits have been depleted.

In general, the great production efficiencies have come from increased mechanization and use of large-scale equipment. If the mining industry is to fill the increased demand for its products from less desirable deposits it will have to turn to heavier and heavier capital investment. The mining companies included in *Fortune* magazine's most recent survey of the 500 largest corporations had capital assets of $134,000 per employee—by far the largest investment per employee for any category of industry. This figure of $134,000 per employee is understandable when you realize that some companies are now hauling ore from open pits in trucks that carry over 100 tons a load. A 100-ton truck may cost as much as $185,000. A dragline operated by two men may cost as much as $10 million.

The magnitude of the total investment needed to put a large-scale, mechanized mine in operation is so great that it presents unique problems of availability of capital. For example, the Kennecott Copper Corporation recently spent $100 million in a program at its Bingham Canyon open pit copper mine in Utah merely to maintain copper production at its past levels. The Freeport Sulphur Company is considering a program for an Indonesian copper deposit in a remote area, where transportation facilities will have to be built as well as mining facilities, and it is anticipated that the cost will be in excess of $100 million.

The long lead-time—which means funds expended may not begin to yield a return for years—intensifies the industry's capital problems. For example, American Metal Climax, Inc. is engaged in a project to bring the Henderson molybdenum mine, located in Empire, Colorado, into production. The total outlay will be approximately $200 million. The mine will have a capacity of 50 million pounds of molybdenum a year. It has already been in development for 4 years, and it will not be producing until the mid-1970's.

In connection with the rising cost of mining, it should be pointed out that additional costs have already been imposed upon the mining industry in connection with pollution control, mine reclamation, and mine safety. Mentioning these facts should not be construed to indicate that the mining industry is opposed to reasonable regulations in these three areas, but merely to direct attention to additional cost factors that already must be taken into consideration by a mining company in determining whether to go forward with a projected mining operation.

The decision to undertake a mining operation is made, in its simplest terms, by comparing the rate of return—after income taxes—on the funds that must be tied up in the project with the after-tax yield if the funds are invested in something else, taking into account differences in risks. In making the necessary projections before a new project is undertaken, a company will make its computations of after-tax rate of return and cash flow on the basis of the deductibility of preproduction expenditures and on the basis of the depletion allowances.

If depletion deductions are cut, some of these projects simply will not pass the test of an acceptable after-tax rate of return at present price levels. In the long run, failure to develop new sources would cut mineral supply. The effect would be to slow down the development of the whole economy and by imposing higher costs for minerals would eventually result in passing on the additional tax burden to the mineral consumers.

It would be a great mistake to view the mining industry as a static industry where the government could reap a windfall in tax revenues by cutting back on deductions on existing operations after the mining companies were committed to these operations on the assumption that the present tax treatment would continue. Entirely aside from the unfairness of such an approach, it would be self-defeating because the mining industry is not a static industry. Our economy is dependent for the foreseeable future on the mining industry making the investments necessary for a tremendous increase in production. We operate in a free enterprise system and we depend upon the after-tax rate of return to direct the flow of capital into one industry or another. Even if the managers of the mining companies wanted to make unprofitable investments in further increases in production, the capital would simply not be forthcoming. Investors would no longer be attracted to the industry. The mining industry must be able to offer investors at least a rate of return that is competitive with other industries. It should be able to offer a better rate than other, less risky investment prospects.

To put it simply, if the country expects the mining industry to generate the investment capital to meet the increased demands of the future as it has successfully met increased demand in the past, then the present depletion rates should not be cut.

In view of the phenomenal projected mineral needs for both the United States and the rest of the world, it seems clear that to achieve any progress we must move forward from existing policies rather than to cut back. Clearly, a cut in depletion would increase costs, rendering already low-grade domestic mines even less economically viable, and making United States-owned foreign ventures less competitive vis-a-vis foreign-owned enterprises seeking the valuable deposits in the emerging countries. This nation can ill-afford such a "giant step backwards."

The importance of the after-tax rate of return is illustrated by the example of one company that has reported to us that it went into a uranium mining operation several years ago, at a time when uranium had an uncertain future, on the basis of a discounted cash-flow rate of return analysis that showed the return on a 1,000 ton-per-day operation would be reduced by more than 75 percent if the 23 percent depletion allowance for uranium were not taken into account. The company reported that it undoubtedly would have decided to discontinue the operation in the absence of the depletion deduction. Another company has estimated that its sales price for uranium would have to be increased more than 10 percent to maintain the same net after-tax income if the percentage depletion allowance were to be eliminated. Another company that has opened a relatively small copper-zinc mine in a depressed area—an operation that required an initial outlay of more than $4 million—reported that under the discounted cash flow method it uses to evaluate investments, it is doubtful that it would have undertaken the project if it were not for the percentage depletion deduction.

Perhaps a more striking example of the importance of the present tax treatment is a case described to us by a company that was considering developing a copper deposit in an African country. This country required, however, that the mine be owned and operated by a corporation organized under the laws of that country. The effect of this would have been that when the income from the mine was first subject to tax by the United States it would be subject to tax as dividend income and thus would not be eligible for a percentage depletion deduction. The company eventually decided to withdraw from the project, though it had spent several hundred thousand dollars on it, because the inability to use the percentage depletion deduction reduced the after-tax return to the point where it was no longer an economically viable investment. This deposit was subsequently developed by foreign companies.

The present tax treatment of the mining industry has been built into the investment structure of the industry, and into its price structure. Decisions to open new mines or expand existing mines have been made on the basis of the present provisions of the Internal Revenue Code. The prices charged for mineral products and, indirectly, prices throughout the economy have been determined by the supply of minerals evoked by the present tax structure.

Annual surveys of the First National City Bank for the years 1960 through 1968 show an average profit after taxes as a percentage return on net worth of 11.2 percent for the mining industry compared with 12.15 percent for manufacturing industries. It is clear from these figures that the owners of the mining companies are not getting an undue profit after taxes because of their tax treatment.

It would be ironic if the Senate should cut back on depletion rates for the mining industry in the same Congress in which it passed S. 719. In passing S. 719, the Senate has endorsed the principle of recognition of the national interest in the American mining industry. Surely the first token of that recognition will not be an increase in tax burden aimed directly at the mining industry.

We strongly urge that depletion rates applicable to the mining industry under present law be retained by this committee.

Inconsistencies in depletion rates under the bill

The blanket reductions were made without regard to the fact that coal logically should have been in a higher rate category than 10% before *any* reduction was applied since all other fuels have higher rates and the general category of "other minerals" has a rate of 15%. For example, if coal were to be treated as entitled to a 15% depletion rate before any cuts were considered, then even the the 26.6% cut proposed in the House bill for minerals entitled to the 15% depletion rate would leave it with depletion at the rate of 11%.

Even those minerals that were expected in the House bill from the cut in the 15% depletion rate (gold, silver, oil shale, copper, and iron ore) were excepted from the cut only with respect to domestic deposits. Since we are concerned with the scarcity of these minerals and since we must rely on foreign sources (except in the case of oil shale), there is no reason for cutting their depletion rate in the case of foreign deposits.

Technically, it is not clear what the provision in the bill for a 15% rate for domestic gold mines and silver mines actually means. With occasional exceptions, gold and silver are produced in this country as by-products from mines whose products of principal value are lead, zinc, or copper. While historically the reference in the law to "metal mines" has been interpreted as providing a depletion rate for metals not otherwise provided for by name in the Code, this interpretation is proposed to be overturned in the pending proposed regulations under section 613. These proposed regulations would treat as eligible for the present 15% rate for metal mines all mineral products from such mines, whether these products are metals or not (unless the products are eligible for a 23% rate under section 613(b)(2)(B)). If this interpretation, which we think is erroneous, should be applied to the House version of H.R. 13270, the 15% rate for gold or silver mines in the United States would presumably not be available for gold and silver produced from other metal mines in the United States. For example, the rate of depletion on silver from a lead-zinc mine might be cut to 11%, even though the depletion rate on the lead-zinc itself would be 17% (23% under present law). Furthermore, under this interpretation, the effect of the language of the House bill would be to reduce the depletion rate on iron ore from a domestic mine from 15% to 11% where the iron existed in the ground in combination with other metals if the predominant value of the product from the mine was of the other metals or minerals. This is not a theoretical example; it occurs where iron sinter (which is in direct competition with the iron in taconites) is obtained from sulfide ore. This is a technical problem that could be solved by deleting the word "mines" from proposed section 615(b)(3)(A).

EFFECTIVES DATES

The bill as it passed the House is inconsistent in its treatment of effective dates for the various provisions. Retroactive application of taxes should be avoided wherever possible. Otherwise, some taxpayers will be taxed under provisions of which they had no knowledge. This is true even though a provisions is made effective on the date of some announcement by the Ways and Means Committee or on the date that some proposal was made by the Treasury Department. All taxpayers cannot be expected to keep in touch that closely with legislative developments. In fact, in a complex area such as the tax law, taxpayers find it difficult to keep up with Changes actually enacted into law.

An example of a retroactive effective date is the one proposed with respect to mineral production payments. Treatment of such payments as loans is made applicable, in the House bill, to production payments created on or after April 22, 1969. Another example is in the application of recapture rules to section 615. These rules would be effective for exploration expenditures after July 22, 1969.

We suggest that all the tax-imposing provisions of the bill be applied prospectively only.

MINING EXPLORATION

The bill makes the so-called recapture provisions of section 617 applicable to expenditures after July 22, 1969 to which section 615 applies. It also allows foreign exploration expenditures to qualify for deduction under section 617 subject to a $400,000 limitation on total expenditures. The net effect of the two changes is virtually to eliminate the difference in tax effect between section 615 and section 617. Under the bill, both sections will apply to foreign as well as domestic exploration expenditures (within the $400,000 limitation) and deductions under both will be subject to recapture—that is, the amount of exploration deduction previously taken on a property that becomes a producing mine will be recaptured either by immediate inclusion in income or by denying an equivalent amount of depletion deductions for the mine. The only difference remaining between section 615 and 617 treatment is that there will be an overall limit of $400,000 on deductions under 615, including domestic as well as foreign exploration expenditures, whereas domestic exploration expenditures in excess of $400,000 can be deducted under section 617.

Under these circumstances, it would be unfair to hold taxpayers to an earlier election to deduct exploration expenditures under section 615 instead of under section 617. The reason for electing section 615—i.e., no recapture—disappears under the bill, so taxpayers should no longer be bound by their earlier election of section 615 now that the terms of the provision on which the election was based have been changed. We urge that taxpayers be permitted another election between deducting exploration expenditures under section 615 and under section 617.

In revising the Code provisions for mine exploration deductions the Committee should take this opportunity to make it unmistakably clear that expenditures after a mine reaches the development stage are not to be treated as exploration expenditures for tax purposes. Instead, they are either development expenditures or production expenditures after the mine has left the exploration stage. It would seem unnecessary to labor this obvious point in view of the statements in this Committee's report on the 1951 Act when the predecessors of the present sections 615 and 616 were enacted, but there has been a persistent misunderstanding of Congress' intent, culminating in an interpretation by the Court of Appeals for the Seventh Circuit in its opinion in *Santa Fe Pacific Railroad Co.* v. *United States*, 378 F. 2d 72 (7th Cir. 1967). Regardless of whether or not the Court reached the correct result on the facts in that case, the opinion misinterpreted the consequences Congress intended to be drawn from the shift from the exploration stage to the development stage. The opinion in the *Santa Fe* case reached the remarkable conclusion that, having provided for deduction of exploration expenditures (within limits) during the exploration stage and having provided for deduction of development expenditures after the mine reached the development stage, Congress meant to treat taxpayers as having exploration expenditures after the exploration stage had ended that were not deductible either as exploration expenditures or as development expenditures.

A fair reading of the Treasury Regulations under sections 615 and 616 bears out our interpretation. See Regs. §§ 1.615–1(a) and 1.616–1(a). We suggest that the Committee state in its report on the mine exploration expenditure provisions of this bill, that expenditures afer the development stage is reached are to be treated as development (or production) expenditures.

MINERAL PRODUCTION PAYMENTS

We believe that we should bring to your attention a discriminatory effect that would result if the provision of the House bill that would treat sales of carved-out mineral production payments as loans is adopted in its present form. Production payments are a type of advance sales. The abuse in the use of carved-out production payments was cited in the Ways and Means Committee report as primarily involving the impact of the 50 percent of net income limitation on the percentage depletion deduction. The discrimination arises from the fact that all other taxpayers have the opportunity of accelerating income for other purposes through advance sales. Under the loan approach in the House bill, this right would be taken away from the mining industry where advance sales are accomplished by carving out and selling mineral production payments.

The American Mining Congress believes that if proceeds from sale of mineral production payments are treated as loans for purposes of depletion computations, the mining industry should not be prevented from accelerating income for other purposes on the same basis as other taxpayers.

DEPRECIATION

Section 521 of the House bill would deny 200% declining balance and sum-of-the-years digits depreciation on new real estate construction (other than housing). The provision in the House bill appears to go far beyond the alleged abuse at which it is aimed. Industrial buildings constructed by the business firms that use them have not been used for quick write-off and resale at capital gain rates. Any possibility of abuse in the case of industrial buildings can be guarded against by providing for full recapture at ordinary income rates of all depreciation deductions previously taken against profit on disposition. It is not desirable to discourage investment in such buildings by denying the depreciation deductions in early years that are provided by present law.

We suggest that buildings constructed by mining companies to house their mining and beneficiation facilities and for related operations be permitted to continue the use double declining balance and sum-of-the-years digits depreciation with full recapture of excess depreciation as ordinary income against profit on sale.

We also suggest preservation of the simplicity and certainty of the depreciation guideline lives by law so that taxpayers may continue to use useful lives at least as short as guideline lives without regard to the reserve-ratio test. Taxpayers who wish to establish useful lives shorter than guideline lives should be allowed to use the reserve-ratio test to establish their eligibility for such shorter lives.

SECTION 213 OF THE BILL

Section 213 of the bill is designed to curb the use of so-called "hobby loss" deductions to offset income. While the problem is one of deduction of expenditures that are for the personal enjoyment of individuals, it is not clear that the provision in the bill would be limited to individuals. If it applies to deductions by corporations, then there is a serious danger that it will, at the very least, create an unwarranted presumption of tax avoidance that will have to be rebutted in lengthy disputes with Revenue agents in the case of many—conceivably nearly all—mining companies. This problem with the House bill arises from the failure of the bill to provide a workable standard for recognizing losses incurred for the personal enjoyment of individuals and from the fact that the bill would apply to an "activity" carried on by a taxpayer, without defining "activity". If an "activity" means sometimes less than a trade or business, then many "activities" carried on by mining companies in the course of conducting their businesses might be considered as carried on without a reasonable expectation of realizing a profit. We urge that, if section 213 is retained in the bill, it be revised to make it clear that it does not apply to unprofitable activities carried on as segments of an overall trade or business conducted with a reasonable expectation of realizing profit.

FOREIGN MINING

Percentage depletion on foreign mines and deposits should be retained

While the House bill does not repeal percentage depletion on foreign mines and deposits in the case of the hard minerals, amendments have been offered to this Committee that would do so. Furthermore, the House bill has cut the depletion rates on all minerals from foreign deposits and has eliminated foreign percentage depletion in the case of oil and gas wells outside the United States.

Enactment of legislation that would eliminate percentage depletion on mines located outside the United States would violate the principle of tax neutrality. Any cuts in depletion rates on foreign deposits would be detrimental, not only to our mining industry, but to our country as a whole.

United States policy toward the development and operation of foreign mining by United States companies should not vacillate from year to year. If our Government discourages foreign mining, even for a short period of years, we will have to live with the consequences for generations. The results of a repeal of percentage depletion for foreign mines by our Government would be irreversible because the foreign mineral deposits that would be developed by nationals of other countries as a result would be lost to our companies forever—even though the minerals are essential to our domestic economy.

The Treasury has stated to the Committee that it is presently developing and plans to present to Congress comprehensive proposals relating to the U.S. taxation of foreign income. A thorough review of our present philosophy toward the taxation of foreign income is certainly desirable, and, with that review in prospect, it seems pointless for the Committee to develop detailed modification of the present system in this bill. Furthermore, if there are basic charges made later in the system for taxing foreign income it will be necessary to adopt complex provisions for phasing out the provisions of sections 431 and 432 of the House bill. We suggest that the entire subject of foreign tax credits and changes from domestic depletion rates be put over for consideration when the Treasury makes its comprehensive proposals.

Minimal revenue from increasing United States taxes

The United States would gain virtually no revenue from denying or reducing percentage depletion on foreign mineral deposits or other similar tax changes. Foreign mining income is subject to income tax in the foreign country, which is eligible for credit against United States tax. Where the effect of eliminating or cutting foreign depletion deductions is to raise the U.S. effective tax rate above that imposed by the foreign country, the foreign country can be expected to raise its own taxes by an equivalent amount.

The sentiment encountered in the countries in which mineral resources are located, even though generous tax incentives are offered by them, is these countries are determined that taxes on income earned therein should be paid there rather than to the country from which the investment originated.

Many provisions in foreign countries for reduced tax rates are explicitly geared to the tax rates in the capital exporting country. For example, in Peru, Article 56 of the Peruvian Mining Code, as amended by Law 16892, promulgated February 4, 1968, after providing for reductions of tax rates on income from mines or ore deposits by executive agreement, provides, "The aggregate of the profits tax rate plus that of the complementary tax, in case of foreign enterprise, shall in no case be less than the global rate of tax charged in the country or countries where the investments originate, provided that the differences entail obligation to pay taxes in those countries." In other countries tax agreements made with individual companies provide for increasing rates to offset any increase in United States tax.

In any event, the existence of an *automatic* provision for increasing taxes to offset an increase in our taxes merely means that the offsetting will take place immediately. In other countries the same result will follow gradually, so that any appreciable increase in revenues to the United States Treasury will soon disappear.

The Committee report on the House bill recognizes, in giving the revenue effect of the provision to deny percentage depletion on foreign oil and gas wells, that any theoretical revenue gain will be eliminated in later years by increased foreign taxes. The report says, "Although a more substantial gain of $90 million appears possible from repeal of foreign percentage depletion, it is assumed that in early years these gains will be partially offset by unused tax credits and in later years will be eliminated by increased foreign taxes." (Part 1, p. 138.) Thus, the effect is to increase the tax cost to United States taxpayers without increasing our Government's revenues. In the words of Assistant Secretary Cohen's statement to the Finance Committee, "The end result will be that the U.S. taxpayer will pay additional taxes to those countries but no additional tax to the United States."

In some countries the tax laws contain percentage depletion deduction provisions modeled after ours—sometimes with the same depletion rates as are provided in our law. Obviously, we could not expect those rates to remain in effect if we were to eliminate or reduce percentage depletion on foreign deposits.

Discriminating against foreign mining violates the tax neutrality concept

If Congress were to change the tax law to discriminate against foreign mining this would be contrary to the principle of tax neutrality that is the theoretical justification for the United States taxing income worldwide.

A strong government can be made for taxing only income that is earned in this country. Our Government has rejected that approach, however, on the theory that, insofar as our tax rates control the situation, the income of a United States-based firm should be taxed on approximately the same basis regardless of where it arises. So long as we follow that principle, we should not discriminate against income from foreign sources. Elimination of percentage depletion on foreign mineral deposits would, of course, do just that.

Thus, if Congress continues the policy of taxing United States taxpayers on their worldwide income to achieve tax neutrality, foreign mining should not be discriminated against in our tax system.

Our reliance on foreign minerals

At the outset it should be recognized that the mining industry must go where the minerals are. And many of them are not in the United States—in some cases domestic reserves can supply a part of our requirements, and in other there are no domestic reserves. The following table shows imports as a percentage of United States consumption in 1967 for the most important minerals:

TABLE 1

Metals and nonmetals—Imports as a percent of consumption, 1967

	(Imports as percent of consumption)
Metals:	
Bauxite	80.5
Beryllium (11 percent BeO)	100.0
Cadmium	13.7
Cobalt	58.8
Copper	33.5
Gold	14.8
Iron Ore	35.0
Lead	41.2
Manganese Ore (35 percent or more Mn)	86.6
Mercury	35.0
Molybdenum	2.0
Nickel	82.3
Platinum Group	91.4
Silver	32.5
Tin	66.3
Titanium:	
(a) Ilmenite concentrate	22.6
(b) Rutile concentrate	100.0
Tungsten	12.3
Uranium (U_3O_8 content)	14.8
Vanadium	.8
Zinc	41.0
Nonmetals:	
Asbestos	89.5
Barite (primary)	38.8
Boron	32.0
Clays	.2
Diatomite	0
Feldspar (crude)	.1
Feldspar	83.6
Graphite (natural)	100.0
Mica:	
(a) Block and film	93.6
(b) Splittings	78.9
Phosphate Rock	.5
Potash (K_2O equivalent)	41.2
Salt	6.9
Sulfur and pyrites	17.6

NOTE.—Data based on 1967 Minerals Yearbook, vol. I and II, Metals, Minerals, and Fuels, U.S. Bureau of Mines. U.S. Bureau of Mines' Commodity Statements (supplement to Bureau of Mines' Strategic Plan), January 1969.

The same point is illustrated by the following table, which shows United States production of a number of minerals in 1967 as a percent of world production:

TABLE 2

United States mineral production as a percent of world production, 1967

(U.S. production as a percentage of world production)

Mineral:	*Percent*
Cement	14
Feldspar	39
Fluorspar	13
Gypsum	42
Phosphate rock	46
Potash	20
Salt	35
Sulphur elemental	47
Bauxite	4
Copper (content of ore and concentrate)	17
Gold	4
Iron ore	13
Lead (content of ore and concentrate)	10
Mercury	10
Molybdenum (content of ore and concentrate)	71
Nickel	3
Silver	12
Tungsten concentrate (60% tungsten dioxide)	14
Vanadium	47
Zinc (content of ore and concentrate)	10

Source: *Minerals Yearbook*, 1967, vol. I II, table 62, p. 59, and vol. III, table 10, p. 37.

Even the present relationship of domestic production to domestic demand understates our future dependence on foreign sources for minerals. As we pointed out earlier in this statement, the Bureau of Mines is predicting United States mineral demand to increase by more than four times by the year 2000, whereas domestic mineral production projected on the basis of 20-year trends can only be expected to little more than double by 2000 Furthermore, the Bureau of Mines is predicting a five-fold increase in worldwide demand for minerals by the end of the century.

Thus we are faced with a widening gap between domestic mineral supply and domestic mineral consumption, and the problem of obtaining adequate supplies from foreign sources is complicated by an even more rapid increase in foreign demand for minerals.

Facing this future, *any* changes in our tax laws that would discourage American mining firms from securing and developing foreign mineral deposits would be contrary to the national interest.

Our interest in controlling foreign mineral sources

There is a clear national interest in the control of foreign mineral sources to assure an adequate supply of basic minerals for domestic need. The world supply of commercial mineral deposits is limited, and other industrialized countries are actively acquiring control of foreign mineral deposits.

A further important advantage of having the foreign sources of minerals for United States consumption owned by United States firms is the assurance of reasonable prices. The United States should not let itself get into a position where it can be exploited by foreign producers withholding supplies from the market or exerting monopolistic pressures to force payment of unreasonably high prices.

Furthemore, foreign operations that are United States owned will buy machinery and equipment from United States manufacturers and the engineering and construction will be performed by U.S. companies. Additionally, U.S. owned companies are more likely to use U.S. smelters and refiners to process their foreign ores and concentrates.

Balance of payments benefits

United States ownership of foreign mineral operations benefits our balance of payments. Direct foreign investment in mining and smelting abroad, according to the Office of Business Economics in the Department of Commerce, produced a total dollar inflow over the eight-year period, 1960–1967, of over $3.2 billion, of which $2.2 billion were from branch profits, $940 million were from dividends, and $85 million were from interest. Reflecting a steadily rising trend, the 1967 figures totaled $596 million, composed of $413 million branch profits, $167 million dividends, and $16 million interest.

Taking into account the inflow from royalties, license fees, rentals, management fees, and service charges, total mining and smelting dollar inflow exceeded net capital outflows by more than $2.1 billion for the eight-year period, 1960–1967. The net capital inflow for 1967 was $320 million. (The outflow figures for these statistics are contained in the October 1968 edition of the *Survey of Current Business* published by the U.S. Department of Commerce. They include reinvested earnings of foreign branches as well as net capital transfers by United States parent companies.)

Thus the mining industry is now making a substantial contribution to our balance of payments—even when only the direct benefits from remitted profits are taken into account. Other indirect benefits include lower cost imported raw materials than would be possible if they were purchased from foreign-owned companies and better opportunities for our exporters to supply machinery and equipment to mines owned by United States firms.

The profits remitted to the United States are derived only in part from supplying minerals to the United States; they also result from supplying foreign ores and concentrates to foreign markets. These foreign markets will offer increasing opportunities as other countries increase their level of industrial activities and require more mineral supplies.

Erosion of tax incentives offered by foreign countries

If depletion deductions are eliminated or reduced, or if changes are made in the foreign tax credit that result in higher effective U.S. tax rates on foreign mining, the tax incentives offered by many foreign countries will be undercut.

A substantial number of foreign countries are still eager to encourage private capital to develop their mineral resources. To make this possible they offer a variety of measures to lower the income tax burdens of the mining companies—resulting in tax rates that are comparable to U.S. effective tax rates with percentage depletion. Typical effective tax rates applicable to mining income are 37% in Indonesia, 40% in Nigeria, 36% in the Philippines, 25% in Thailand, and 33⅓% in Canada.

As an example, in Indonesia, following the overthrow of the Sukarno regime in 1965 by the present Suharto government, the government enacted Law No. 1 on January 10, 1967. The purpose of Law No. 1 was to provide a favorable climate so, as the preamble of the law states, "that foreign capital should be utilized to the maximum extent to accelerate the economic development of Indonesia and to be used for fields and sectors which within a short time cannot as yet be achieved by Indonesian capital itself." Law No. 1 provided the authority for the government in their contract negotiations with potential foreign investors to grant specific tax exemptions and relief in the form of lower corporate tax rates, a tax holiday period up to five years, exemption from taxes on dividends, exemption from import duties, accelerated depreciation, carryover of operating losses, and other tax incentives. Pursuant to Law No. 1, the Indonesian Government, in 1968, promulgated Mining Regulation No. 18/1968. Besides other tax incentives, this law reduced the Indonesian corporate income tax rate of 60% to tax rates as shown in the table on the following page.

[In percent]

Category of minerals	Corporate tax rate: 1st to 10th year	Corporate tax rate: 11th to 30th year
(1) Copper, lead, zinc, iron, titanium, manganese, mercury, molybdenum, antimony, asbestos, chromite, iodine, natural asphalt, diamond, sulfur, kaoline, and jarosite	35.0	42
(2) Nickel, cobalt, bauxite	37.5	45
(3) Tin	40.0	48

These lower tax rates would become meaningless to United States companies if U.S. percentage depletion on foreign deposits were repealed.

Tax treatment of companies from competing countries

United States mining companies compete with companies from other developed countries for the opportunity to develop and operate foreign mines. Many of these countries actively assist their nationals through favorable tax treatment. These include the following:

France: Unless they elect a different type of tax treatment, French companies are exempted from tax on income from foreign sources.

French companies may elect to consolidate one or more of their foreign branches or subsidiaries, subject to Government approval, for an agreed period. In such case nonferrous mining operations have a 15% depletion allowance for three years (with a 50% of net income limitation), with the depletion allowance placed in a reserve for reinvestment within five years. Electing companies can credit foreign tax against French tax, subject to a per country limitation.

Japan: Although Japan has a 48% effective corporate tax rate and a Japanese company is taxed on its worldwide income (with a foreign tax credit allowed), a Japanese company can charge up to 50% of its investment in a less-developed country against taxable income. This is an addition to a reserve that must eventually be restored to income, but, in effect, the taxes may be deferred up to 10 years.

Netherlands: Although the Netherlands provide no specific tax incentives for investments by a Dutch company in a less-developed country, if a Dutch company operates abroad through a foreign subsidiary the profits generated by the foreign subsidiary are not subject to Dutch income tax when they are repatriated. The only requirement for this treatment is that the subsidiary's profits be subject to tax in the foreign country—regardless of the form the tax and no matter how low the tax rate.

If American mining companies operating abroad are handicapped by a heavier United States tax burden they will be placed at a serious competitive disadvantage vis-a-vis firms based in countries whose tax systems do not negate the advantages offered by countries with undeveloped mineral resources or, in some cases, actively encouraged investment in these countries.

Investment by U.S. companies in foreign mining has been concentrated in Canada and in the less-developed countries, as is evidenced by the following table showing mining and smelting foreign direct investment at the end of 1967.

TABLE 3.—MINING AND SMELTING INDUSTRY YEAREND BOOK VALUE BY MAJOR AREAS, 1967

	Millions	Percent
Canada	$2,337	48.5
Latin American Republics	1,218	25.3
Other Western Hemisphere	431	9.0
Africa	398	8.3
Oceania	322	6.7
Europe	61	1.3
Asia	43	.9
Total	4,810	100.0

Source: U.S. Commerce Department, Survey of Current Business, October 1968, table 3, p. 24.

While Canada has by far the largest share of our foreign mining investment, even there a large share of the investment is in areas of Canada that are not themselves developed.

In addition to the obvious economic advantages to the United States of developing the mineral resources of foreign countries, important foreign policy considerations are involved. The United States has a vital interest in helping less-developed countries, and certainly should not revise its tax system to undercut the attempts of these countries to attract private capital for development.

The arguments set forth above with respect to reduction or elimination of percentage depletion on mineral deposits located in foreign countries apply with equal force to any reduction of percentage depletion generally or to changes in the application of the present U.S. foreign tax credit provisions having the same adverse effect on U.S. mining companies operating abroad as the elimination of percentage depletion on foreign mineral deposits.

Foreign tax credit after loss years (sec. 431)

It is a common occurrence in the development of mining properties to incur heavy expenses during the development stage. These result in losses until the producing stage of the mine is reached. In some cases where mines are developed abroad the foreign countries permit these losses to be carried forward or achieve a similar result by making income from the mine tax-free or by taxing it at a reduced rate during the early years of the producing stage. In other cases, however, the foreign country may provide little or no relief from its taxes on the profits afater the initial losses have ceased and the mine becomes profitable.

The House bill would require a taxpayer using the per-country limitation on the foreign tax credit to carry forward losses incurred in a foreign country and use them to reduce income from such country in subsequent years before computing the limitation of the foreign tax credit to be allowed for income taxes paid to that country. Contrary to the Ways and Means Committee report, this adjustment is not limited to cases where the foreign country loss produced a United States tax benefit. This proposed loss carryover, which works to the taxpayer's disadvantage, is unlimited in time—unlike the usual loss carryforward that is limited to five years.

The justification for this provision given in the Ways and Means Committee report is that under present law a United States taxpayer with losses in a foreign country can obtain "what in effect is a double tax benefit." This is not correct. In fact, he pays no less income taxes. United States and foreign, than a taxpayer with the same income and losses whose operations are all within the United States.

The bill does not take account of the fact that a foreign country may allow losses to be carried back to earlier years (as our own tax system does). Consequently, it may require in total U.S. and foreign income taxes far in excess of the ostensible tax rates in some cases. This is illustrated by the following example of a Canadian branch operation of a U.S. corporation, assuming a 50% tax rate in both the U.S. and Canada:

	Taxable income (loss)	Canadian tax	U.S. tax (per the bill)		
			Gross tax	Foreign tax credit	Net tax
1972	$100,000	[1] 0	$50,000	0	$50,000
1973	(100,000)	0	[2] (50,000)	0	(50,000)
1974	100,000	$50,000	50,000	[3] ($25,000)	25,000
1975	100,000	50,000	50,000	[3] (25,000)	25,000
Total	200,000	100,000	100,000	(50,000)	50,000

[1] 1973 loss carried back to 1972 for Canadian tax purposes. Full refund on 1972 Canadian taxes secured, hence no foreign tax credit.
[2] Assumes other U.S. taxable income in 1973 sufficient to absorb the loss.
[3] Special limitation under the bill.

Note.—Total tax: $150,000; overall effective tax rate: 75 percent.

If this provision of the House bill becomes law, the effect will be to impose higher income tax burdens on taxpayers with foreign operations—contrary to the principle of tax neutrality that is used to justify imposing United States tax on foreign income. Essentially, the complaint should be directed against the foreign taxing authority that fails to allow the initial years' losses to be carried forward, rather than against the United States taxpayer. Instead of sacrificing the United States taxpayer as the House bill would do, the Treasury might attempt to negotiate tax treaties with the countries involved to coordinate their tax treatment with our own. We urge that this unjustified restriction on the foreign tax credit be eliminated from the bill.

If this provision is retained in the bill, at least it should be rewritten to establish as a general principle that it will apply only to the extent foreign losses are actually utilized to reduce tax on income from domestic sources and that the losses so utilized will be taken into account in computing the percountry limitations for subsequent years only when the foreign country has not allowed the loss either as a carry-back or as a carry-forward or through the provision of tax holidays or exemptions.

Special foreign tax credit limitation on mining income (sec. 432)

The House bill would apply a separate limitation on the foreign tax credit with respect to all mining income from each country in which any property producing mining income meets one of three tests. The committee report says that these tests are "to isolate those cases in which it is likely that the income taxes represent, at least in part, royalties." The three tests are whether the foreign country:

(1) require payment of a bonus or royalty,

(2) holds substantial mineral rights with respect to the property, or

(3) imposes any income taxes on mining income at an effective rate higher than on other income.

The three tests are treated as conclusive presumptions that the income taxes paid represent royalties to some extent, yet they are, at best, flimsy reasons for even suspecting that the taxes represent royalties. The fact that a royalty *is* paid is certainly not an indication that the tax paid is *also* a royalty. The fact that the foreign government holds mineral rights is no indication that a royalty is appropriate—for instance, taxpayer may by paying substantial royalties to other persons with interests in the minerals or in the surface lands. Finally, the effective tax rate is ambiguous in its application and even if the tax rate is higher on mineral income, the reason may be based on some policy consideration of the foreign government that has nothing to do with substitution for a royalty.

Even if the tests were valid, it would be unfair to impose the special limitation with respect to *all* mineral income from a country because the foreign government holds rights of some sort in a portion of it. Any limitations based on these tests should be applied only to the excess amounts determined to be royalties, rather than applying to the entire amount of the taxes on mining income paid to the country. Furthermore, this provision is more harsh than the Administration proposal that Congress rejected in 1963, which at least would have permitted foreign income taxes paid on mining income in one country to be credited against U.S. taxes on mining income in other foreign countries. Finally, the illogic of this provision can be illustrated by the fact that it will apply to to a situation where the foreign tax rate plus the royalty paid to the foreign government is less than the tax rate paid by other types of taxpayers in the same country.

In many cases mining companies process their minerals in a foreign country beyond the depletion cut-off point under section 613. For example, ore may be mined in a foreign country and converted or transported in nonmining operations in the same country. Under the provision in the bill, the income attributable to processing beyond the depletion cut-off point would not be mineral income and, therefore, would require a different limitation computation for foreign tax credit purposes. The foreign government, however, will continue to impose a single income tax on the profit from the entire operation (as we do in this country), and it would be unfair to divide this tax arbitrarily and compute the foreign tax credit for each portion under a different limitation.

This provision would penalize taxpayers paying bona fide foreign income taxes by presuming conclusively, without any inquiry into the facts, that all the foreign taxes on mining income are royalties. The Mining Congress urges that this attempt to fragment the foreign tax credit be eliminated from the bill.

The Treasury's suggested alternative to section 432

The Treasury opposes the provisions of section 432 of the House bill, citing as the basis for its opposition some of the same objections that we make here. The Treasury has, however, recommended an alternative to section 432 that is based upon the belief that, somehow, there is a "special problem connected with foreign mineral income." The Treasury's alternative would deny use against other foreign income of excess foreign tax credits that result from the U.S. percentage depletion deduction.

This alternative is not as onerous as section 432 of the House bill, and it is not based upon the contrary-to-fact assumption that virtually every foreign income tax on mining income is in part a royalty. There are, however, serious objections to the Treasury's proposed alternative. It is a variation on a proposal that was made by the Treasury in 1963 and 1964 and finally rejected by Congress when the Revenue Act of 1964 was passed.

The Treasury proposal is subject to the criticism that it attempts to segregate a specific category of income and compare the U.S. and foreign income tax rates on it. While this has the appearance of precision, the appearance is illusory because neither the United States nor most foreign countries really impose schedular taxes on separate categories of income without regard to their impact on the taxpayer. Furthermore, it is not fair to segregate the activity of mining up to the depletion cut-off point from all the other related activities that a mining company engages in in a foreign country. Many of these other activities, such as the operation of railroads, warehouse and shipping facilities, stores, and power plants, are required because of the absence of an adequate economic infrastructure to support mining activities in the less developed countries. Also, in more and more cases the mining companies are finding it necessary or advisable to extend their operations in foreign countries beyond the pure mining stage to include further activities such as smelting, refining, and even processing into finished products. It would be highly artificial and unfair to segregate the profits from strictly mining operations from the activities beyond the mining depletion cut-off point and apply a separate foreign tax credit limitation to them.

The principal effect of an excess foreign tax credit is in averaging out the impact of U.S. and foreign taxes over a period of years. The net effect is that the company pays a total tax at least equal to the effective United States tax rate.

If the approach suggested in the Treasury alternative should be adopted, the U.S. would be taking a step toward an infinitely more complex foreign tax credit system in which we would engage in a hopeless attempt to match foreign taxes against U.S. taxes on an item-by-item basis.

We urge rejection of the Treasury alternative proposal as well as section 432 of the House bill.

Sixty percent limit on creditable foreign taxes

The Treasury's comments on the House bill mentioned the possibility that foreign tax credit might be denied to the extent that foreign taxes exceed 60% of foreign mineral income from a particular country. This is not recommended by the Treasury, however, and, after pointing out that not all high foreign tax rates can be properly characterized as royalty substitutes and that it is difficult to justify treating high foreign mining taxes differently from other high foreign taxes, the Treasury statement concludes its discussion of the point by stating, "we believe it preferable to deal with high foreign tax rates in a general context". It is difficult to understand why the Treasury found it necessary to discuss the point at all at this time since it prefers to postpone consideration until it brings up its comprehensive proposals on U.S. taxation of foreign income. We certainly agree that it would be inappropriate to adopt any such limitation on the foreign tax credit at this time.

In a sense, denying foreign tax credit on taxes in excess of a specified rate is a form of interference with the taxing system of a foreign country. Furthermore, if applied to a specific type of income such as mining income, the limitation is subject to the criticism, made above, that it unrealistically fragments the foreign taxes that are imposed on operations in the foreign country as a whole.

Such a provision would clearly seem to violate our obligations under many of our tax treaties. (Indeed, sections 431 and 432 of the House bill probably also violate our treaty obligations.)

Continental Shelf source rule

The Treasury statement recommends that, for purposes of the foreign tax credit, the definition of the United States be amended to include the continental shelf of the United States "with respect to the exploration for natural resources" and that the definition of "foreign country" should include the continental shelf pertaining to the foreign country. We do not understand the scope of this recommendation, and in fact, we do not understand that the scope of the continental shelf itself has been precisely defined. In view of this uncertainty and in the absence of any demonstrated need for immediate action, we suggest that this proposal be deferred and considered in conjunction with the Treasury's comprehensive proposals on the U.S. taxation of foreign income when these proposals are presented to Congress.

We reemphasize our earlier point that any legislation dealing with the taxation of foreign income should be deferred pending completion of the comprehensive Treasury study of this area.

CONCLUSION

The American mining industry has a vital role in the development and maintenance of our economy. It has performed that role well under our present tax system, and in the process the mining companies have not made after-tax profits out of line with those of industry in general. With an expanding population and an expanding economy before us, the mining industry has an even bigger job to do. It would be the height of folly to set up tax barriers to block the accomplishment of that job by cutting back on the present tax treatment of the mining industry.

Respectfully submitted,

FRED W. PEEL,
Chairman, Tax Committee.

APPENDIX A

NUMBER OF DOMESTIC METAL AND NONMETAL MINES IN 1967, BY COMMODITY AND MAGNITUDE OF CRUDE ORE PRODUCTION

Commodity	Total number of mines	Less than 1,000 tons	1,000 to 10,000 tons	10,000 to 100,000 tons	100,000 to 1,000,000 tons	1,000,000 to 10,000,000 tons	More than 10,000,000 tons
Metals:							
Antimony	6	6					
Bauxite	10	1	2	3	3	1	
Beryllium	5	4	1				
Copper	124	51	11	19	22	18	3
Gold:							
Lode	79	68	6	1	3	1	
Placer	142	86	25	21	8	2	
Iron ore	121	4	11	23	48	31	4
Lead	73	50	9	5	8	1	
Manganese ore	3	1	1	1			
Mercury	119	88	19	12			
Molybdenum	4	1			1	1	1
Silver	74	60	8	5	1		
Tin	4	2	2				
Titanium: Concentrate	6				1	5	
Tungsten	18	10	5	2	1		
Uranium	406	153	90	57	106		
Zinc	173	23	20	45	85		
Other [1]	5	2			3		
Total	1,372	610	210	194	290	60	8
Nonmetals:							
Abrasives [2]	18	8	6	3	1		
Asbestos	9	1	2	3	1	2	
Barite	51	10	9	15	16	1	
Boron minerals	3					3	
Clays	1,280	79	327	697	177		
Diatomite	14	3	4	3	4		
Feldspar	49	26	8	10	5		
Fluorspar	23	4	11	6	2		
Gypsum	75	4	8	26	37		
Kyanite	4				4		
Marl, greensand	2	1	1				
Mica: Flake	20	4	4	11	1		
Olivine	5	1	2	2			
Perlite	16	4	6	4	2		
Phosphate rock	48	1	1	3	20	20	3
Potassium salts	10				3	7	
Pumice	150	34	46	40	30		
Salt	57	1	14	10	26	6	
Sodium carbonate (natural)	3			1	1	1	
Stone:							
Crushed and broken	4,427	207	495	1,502	1,932	290	1
Dimension	547	214	242	83	8		
Sulfur:							
Frasch-process mines	16		2	4	7	3	
Other mines	1	1					
Talc, soapstone, and pyrophyllite	65	13	30	21	1		
Vermiculite	5	2		1	2		
Wollastonite	2	1		1			
Other [3]	12		2	3	7		
Total	6,912	619	1,220	2,449	2,287	333	4
Grand total	8,284	1,229	1,430	2,643	2,577	393	12

[1] Magnesium, nickel, and rare-earth metals.
[2] Emery, garnet, and tripoli.
[3] Aplite, graphite, lithium minerals, magnesite, and sodium sulfate (natural).

Source: Minerals Yearbook, 1967, vols. I-II, table 6, p. 78.

The CHAIRMAN. The next witness will be Mr. Brice O'Brien, general counsel, National Coal Association.

STATEMENT OF BRICE O'BRIEN, GENERAL COUNSEL, NATIONAL COAL ASSOCIATION

Mr. O'BRIEN. Under existing laws the coal industry receives an inadequate rate of depletion, 10 percent, compared to the 15-percent rate extended to minerals in the "all other" category. The House bill will cut coal's rate to 7 percent. We urge that coal's rate be increased to the 15-percent level now applicable to all other minerals.

Coal is an important part of the Nation's total energy picture. The country must have an abundant supply of energy, and most of the energy we use must be supplied from domestic sources if we are to maintain any semblance of a balance of payments.

The Nation's total raw energy bill for oil and gas, uranium and coal is curently about $15 billion a year. Energy consumption is growing so fast that the total bill will be about $30 billion a year in another 20 years.

At the present time the U.S. energy market is peculiarly vulnerable to foreign competition. There is a glut of low cost foreign oil which probably will continue for about 25 years until per capita consumption of energy by the rest of the world increases to the levels necessary to provide a decent standard of living for the rest of the world.

In the meantime the cost of finding and producing oil in foreign countries is so low that import controls and tax incentives are essential if we are to supply the major part of our energy needs from indigenous sources, and we must do that. We cannot permit foreign sources to supply the lion's share of our energy, because if we do so, we will have 20 years from now an energy deficit of $10 to $20 billion a year. And no nation on earth could survive with such a huge trade deficit in one single item.

It is sometimes said that coal does not need a good percentage depletion allowance because very little exploration is required. It is true that we have abundant reserves of coal, sufficient to last for centuries, but coal in the ground cannot be used to produce power or steel. To be useful, there must be sufficient incentive to attract the capital necessary to provide productive capacity, to open new coal mines.

The Nation today is short of coal, and the shortage threatens to increase. The risk to capital is a real deterrent to investment whether that risk lies in the possibility of loss through exploration or in the possibility of loss after productive capacity is installed.

The coal industry has been and is now threatened with loss of investment through many government policies including huge expenditures to develop atomic competition, government stimulation of regulations restricting the use of coal, and the possibility of unlimited imports of cheap foreign oil.

I might point out here that there are no import limitations today on residual oil which directly competes with coal, but if the import limits are lifted on crude oil, that also will compete with coal. Crude oil is selling, foreign oil, at about $2 a barrel. It is easy to transport. If the limits are lifted on that we will find crude oil from abroad replacing coal in the interior sections of the Nation.

These problems are compounded at the present time by the possibility that Congress will enact coal mines health and safety legislation which may force the closing of many coal mines. That legislation is scheduled for the Senate floor this afternoon.

In the fact of all these threats, the coal industry must have a good prospect of net return after taxes sufficient to warrant the risks involved in opening new coal mines.

If that incentive is not present, the capital will be invested in other safer ventures.

The Nation must have coal, with the only alternative being a disastrous deficit in the balance of trade. The Nation will not have coal unless the incentives to invest in new coal production are maintained.

We therefore ask on behalf of the Nation that coal be granted the 15 percent depletion rate currently applicable to minerals in the "all other" category.

Moving briefly to some other problems in the bill before us, first with respect to mineral production payments, we do not maintain that the present treatment should be continued as a permanent part of the tax structure. We do, however, point out that this treatment grew out of the position of the Internal Revenue Service, and we feel justified in asking that its repeal not be retroactive.

Instead of applying to such transactions entered into after April of 1969 as provided in the House bill, the repeal of such treatment should apply only to taxable years after the effective date of the bill now under consideration.

Another item, synthetic fuels. You have under consideration special incentives, including the depletion cutout point, for the production of synthetic oil from shale. Whatever additional incentives are allowed for the purpose of stimulating the production of synthetic fuels from oil shale should be allowed also for the production of synthetic fuels from any other mineral including coal.

When Congressman Aspinall asked for this special treatment before the Ways and Means Committee, he specifically indicated it should apply to all minerals used for the same purpose, and we agree. We point out that the prospects are pretty good that synthetic fuels from coal can be stimulated well prior to the time that synthetic fuels from oil shale are a real commercial possibility.

Another subject: With the repeal of the investment credit, there is a growing need to balance the incentives for the investment of capital in depreciable equipment. This can be done by giving legislative sanction to the existing depreciation guidelines, with simultaneous elimination of the need to meet the reserve ratio test.

The Treasury Department instigated the depreciation guidelines, which admittedly are substantially shorter than useful life. The reserve ratio test is designed to take away, as the years go by, the benefit of the shorter guidelines. But worse than that, the reserve ratio test will make the taxpayer pay additional taxes to pay back to the Treasury the benefit of having had the shorter life in previous years.

There is no sound reason except revenue needs for binding the recovery of investment capital to useful life of the equipment.

The liberalization inherent in the depreciation guidelines has already been absorbed from the revenue standpoint. It should not now be taken away as it will be if the reserve ratio test is not eliminated, and even more important, taxpayers should not now be forced to bear the retroactive penalty of having been granted this liberalization for prior years.

One final point. Instead of eliminating fast depreciation for industrial buildings, such buildings should be included within the depreciation guidelines of the particular industry involved, provided that the revenue is protected by taxing at ordinary income rates all depreciation taken in the future and recovered on sale of such buildings. Industrial buildings do not ordinarily change hands unless a complete business is sold. They are not the type of buildings which lend themselves to any real estate tax shelter, and by providing for complete recapture of future depreciation you would eliminate one possibility that they could be a part of the tax shelter scheme.

Thank you very much.

The CHAIRMAN. What is your reaction to Senator Proxmire's suggestion that depletion allowances are a very inefficient way of developing new reserves?

Mr. O'BRIEN. In my opinion, depletion allowances are a far more efficient method of stimulating production—including the finding of new reserves—than any possible alternative. The alternatives are: (1) direct subsidy or (2) incentive through high prices resulting from shortages.

Direct subsidies for exploration or production lead to waste, and temptations for misappropriation of funds, which inevitably accompany the authority to write Government checks payable to private individuals. In addition, subsidies would substitute the judgment of a Government official for the knowledge and carefulness of the industry man who has been investing his own money.

The other alternative—incentive through high prices resulting from shortages—is not available in the case of energy, unless strict controls on energy imports are maintained. Even then, I believe the economy would be stronger if the incentive is furnished by the tax laws. Minerals—including energy—are at the base of the economy, and if a dollar of cost is added at the base, it will pyramid during the various stages of manufacture to the point where the final consumer will have to pay $2 or $3 in the final product cost for every dollar of cost added at the base.

The CHAIRMAN. Thank you.

Senator GORE. I would like to ask one question:

If you maintain that there must be something other than normal profit as an incentive for investment in coal mining operations, do you think it should be borne by all of the consumers of coal, or, through a subsidy in the form of a special dispensation to the taxpayer who operates in the coal business, by the general taxpayer?

Mr. O'BRIEN. There must be a special incentive for the investment of capital, and the reason there must be is to protect the balance——

Senator GORE. I did not ask you if it was necessary. I assume it is necessary. Which would be preferable?

Mr. O'BRIEN. Let me answer it in this way, Senator. I think it is best borne by all of the people of this Nation, because the reason for it is that the people of this Nation must maintain a balance of trade. The benefit is to the people of this Nation, not to the investor in coal. The need for it arises out of the international balance-of-trade problems. I think it is logical that it should be borne by the Nation as a whole.

Senator GORE. Thank you, Mr. Chairman.

Senator MILLER. In your prepared statement with regard to multiple surtax exemptions, you ask that we retain the present tax treatment if the taxpayer can demonstrate "a sound business reason—independent and apart from tax savings—for the use of multiple corporations." Could you give me an example.

Mr. O'BRIEN. In the case of mining, new ventures can be, and often are, extremely risky and may entail possible losses far exceeding the initial capital investment. In such circumstances it may be prudent for the parent corporation to limit liability by establishing a separate corporation.

Other reasons include: Separate methods of financing may require the issuance of bonds which the parent corporation wishes to restrict to the assets of the separate business.

Again, it may be desired to give employees of the new business a "Piece of the Action."

Or, again, it may be desirable, in establishing a business in a separate state, to limit taxing jurisdiction of the new state by establishing a separate corporation.

(Brice O'Brien's prepared statement follows:)

STATEMENT OF BRICE O'BRIEN OF BEHALF OF THE NATIONAL COAL ASSOCIATION

SUMMARY

I. *Instead of being cut to 7% depletion, coal should be given the 15% depletion rate applicable to the minerals in the "all other" category*—because:

(a) The domestic energy market is (and will be for about two decades) peculiarly vulnerable to imported energy, because there is a short-term glut of low-cost foreign oil and residual oil (which competes with coal in U.S. power plants). Without import controls (and there are none today on residual oil) and without appropriate tax incentives for domestic production, the United States within a relatively short period of years would have an "energy" deficit in the balance of trade amounting to $10 billion to $20 billion—and no country could survive with such a huge trade deficit in one item.

(b) The U.S. has abundant supplies of *coal in the ground*—but we already have a coal shortage and it threatens to get far worse. Government policies in fields other than taxation (such as promotion of atomic competition, limitation of coal's sulfur content, and unduly harsh legislation on mining practices) have reduced the incentive to invest in coal productive capacity. That incentive should not be further decreased by detrimental tax changes. Without incentive to invest in coal mining, the Nation's economy will grind to a virtual halt, because coal is essential to the electric power industry and to the steel industry.

(c) The Nation must have adequate supplies of coal. It is better for the economy to stimulate investment in coal mines through special incentives than through the alternative route—high prices which would follow mineral shortages caused by destruction of special incentives.

(d) Coal is far more important to the economy than many of the minerals in the "all other" category, which currently are allowed 15 percent depletion. Coal currently receives 10 percent and this would be cut to 7 percent by the House bill. Instead, coal should be placed in the "all other minerals" category presently receiving 15 percent.

II. The repeal of present treatment of mineral production payments should be prospective only.

III. Any additional incentives allowed for the purpose of stimulating the production of synthetic fuels from oil shale should also be allowed for the production of synthetic fuels from all other minerals (including coal).

IV. Existing depreciation guidelines should be sanctioned by legislation, with simultaneous elimination of the need to meet the "reserve ratio" test.

V. Instead of eliminating fast depreciation for "industrial buildings," such buildings should be included within the depreciation guidelines of the particular industry involved, with the revenue protected by taxing at ordinary income rates all depreciation taken in the future and recovered on sale of such buildings.

STATEMENT

Mr. CHAIRMAN: The United States has a greater supply of coal reserves than any other country in the world. Yet the United States is already faced with a shortage of coal production—a shortage that threatens to develop into a national crisis. These two statements appear to be contradictory—but they are not. I will explain why this situation has come to pass, and I hope you will understand that while the actions you take in the tax treatment of the industry cannot avoid the forthcoming shortage, they can mitigate that shortage in the future.

The coal industry is an important part of the Nation's total energy picture. Without an abundant supply of energy (most of which must come from domestic sources if we are to maintain a balance of trade), the United States cannot remain a first-class Nation. As the Atomic Energy Commission stated in its 1962 "Report to the President."

"Next to the land, the water, and the air, without which we could not exist at all, energy is by far the most important of our terrestrial resources. Without it our industrial society would be impossible. In common with the other three, it has no substitute."

We cannot afford to import a large portion of our energy. In 1967 the Nation's total bill for raw energy was over 15 billion dollars (domestic crude oil at the well, $8.9 billion; domestic natural gas at the well, $2.9 billion; coal at the mine, $2.6 billion; plus *energy trade deficit*, $1.2 billion). Our 1967 energy trade deficit was composed of a deficit in petroleum and petroleum products of about $1.6 billion, deficit in natural gas of about $65 million, minus surplus in coal exports of about $500 million.

Today's $15 billion a year bill for energy will double in about 20 years—to about $30 billion. The cost of finding and producing foreign oil is so much lower than the cost of finding and producing domestic oil that without import controls a very great share of our energy bill will be supplied by imports. With transportation of liquified natural gas, imports of natural gas will increase by leaps and bounds. Even our low-cost coal is vulnerable to imports—we have in recent years lost most of the utility market on the Eastern Seaboard to imported residual oil. Controls on imports are constantly being relaxed, and there are now serious efforts underway in Congress to eliminate such controls altogether.

Domestic energy markets are extremely vulnerable to foreign supplies of energy, and this situation may continue for as much as 20 or 25 years. American coal can be produced more cheaply than coal anywhere else in the world, but there is a "glut" of foreign oil which may exist for two decades or more (until per capita consumption of energy in the rest of the world increases, as it must eventually). Our domestic oil and gas cannot compete with low-cost foreign oil and gas, and even our low-cost coal is vulnerable to foreign residual oil with its low transportation costs.

We realize the subject before this Committee is taxes, not import controls. But the subjects go hand in hand, where energy is concerned. Without import controls, and without adequate tax incentives for domestic energy sources (oil and gas, uranium, and coal), this Nation within 20 years will have an energy trade deficit of $10 billion to $20 billion a year. No nation on earth—not even the United States—can survive with such a huge trade deficit in a single item.

The picture of future coal production is even more alarming than the general energy picture. Our coal reserves constitute about 80 percent of our total energy reserves (including oil and gas, oil shale, and uranium). But coal in the ground cannot be used to make steel. Coal in the ground cannot be used to generate electricity (and over half of the Nation's electricity today is generated by coal).

Until this decade, the coal industry managed to maintain sufficient productive capacity to meet the Nation's needs (in fact, the industry usually maintained substantial excess productive capacity, so much so that it was able to take up a large portion of the wartime energy demand increases). It did this in spite of several handicaps:

(*a*) The natural risks involved in all mining; that is, unexpected natural conditions underground which can, and often do, result in total loss of investment.

(*b*) An inadequate tax incentive—10% depletion, compared to 27½ for oil and gas, 23 for uranium, and 15% for "all other minerals."

(c) An abnormally low rate of profit during the frequent and prolonged periods when coal was in oversupply.

During this decade, however, the situation has changed very drastically, and we are approaching a drastic energy shortage—particularly a shortage of coal productive capacity—which can cause national disaster by shutting down our steel industry and by shutting down a large portion of the Nation's electric power plants. Coal is already in short supply—and some 25 million tons of coal this year will have to be taken out of the limited stockpiles maintained by consumers. Attached to this statement is a reprint from BUSINESS WEEK of July 5, 1969, entitled "The Coal Bin is Running Short." It tells part of the story. It does not tell all of the story. The reasons why our excess productive capacity has disappeared, and the reasons why the situation is going to become much more critical in the future, are as follows:

(1) With the advent of higher wages in the coal mines, it became necessary to mechanize to the greatest extent possible in order to keep coal competitive with other forms of energy. This greatly increased the capital cost of new mines, requiring a much higher "return after taxes" to make the investment attractive enough to induce necessary risk capital.

(2) Early in this decade atomic power "arrived" as a threat to coal's future in its largest growth market—the utility market. It is now clear that atomic power was "oversold" and that even if the best hopes of the Atomic Energy Commission are realized, the Nation will still need two or three times as much coal by the end of the century, for the production of electricity, as it uses for that purpose today. Nevertheless, the damage was done—the supply of capital for new coal mines dried up, and new mines were opened only after the utility customers signed long-term contracts to buy the coal. The utilities underestimated the need for coal—and there does not today exist the coal productive capacity to fill the gap caused by that underestimate. Furthermore, the confidence of the investor in coal's future is still being undermined by an annual expenditure of $200 million by the Federal Government in an effort to improve atomic power's competitive position vis-a-vis coal.

(3) In recent years, stimulated by the Federal Government, states and municipalities have begun to impose restrictions on the sulfur content of coal—without waiting the few years necessary for full development of the technology to remove the sulfur. This, too, has reduced the availability of risk capital for coal mines.

(4) At this moment, the Labor Committees in both House and Senate are pushing legislation on "health and safety" in coal mining. To the extent that such legislation will actually result in improved health and safety for coal miners, we cannot and do not object to it—but we point out that it will of necessity add substantially to the cost of producing coal, with "guesstimates" ranging in the neighborhood of 20 percent.

Far worse, however, is that these bills as they stand will impose "respirable dust" levels so strict (about twice as strict as the British levels, and Britain has been held up as the "model" in this respect) that the levels may be impossible for a substantial number of mines to meet. This means those mines may have to be shut down, and the capital investment therein lost. Far worse from the standpoint of the country, the coal production from such mines will be lost.

With all these threats—and the difficulty of obtaining an adequate trained labor force—some powerful incentives must be provided for people to risk their money in new coal mines in the future.

Tax incentives alone cannot do the necessary job—if you made the coal industry tax-free, it might not be sufficient in and of itself to overcome all the other government-sponsored threats to investment in new coal mines. But tax incentives can help mitigate the situation. By the same token, tax penalties can make the situation worse. Before setting forth our recommendations for changes in the bill before you, let me point out that the bill contains several provisions which are severely damaging to the coal industry and which thereby decrease the willingness of the investor to open a new coal mine.

(a) The bill repeals the present tax benefits of production payments. While we as an industry have not contended that present treatment should be retained, and while we do not now contend that it should be retained, we do want you to realize that the change is adding a heavy burden to the coal industry.

(*b*) The repeal of the investment credit is a particularly severe blow to the coal industry. As previously stated, a modern coal mine requires a great deal of machinery. Repeal of the credit increases the cost of the machinery, thereby increasing the amount of capital which runs the risk of complete loss because of the many government-sponsored policies outlined above.

(*c*) The bill takes away from the smaller companies (the ones that elected section 615) the ability to deduct exploration expenditures without subsequent "recapture."

(*d*) The extension of the surtax is more damaging to the coal industry than it is to other industries, because of our long-term contracts. Most corporations can and do treat Federal income taxes the same way they treat wages or depreciation—eventually they are passed on to the consumer as just another cost. Because of our long-term contracts the coal industry is unable to do that.

RECOMMENDATIONS

I. Coal should be given the 15% depletion rate applicable to "all other minerals" and the limitation on taxable income from the property should be liberalized for the marginal or near-marginal producers.

Coal is limited to 10% depletion in existing law—and cut to 7% in the bill before this Committee. Without disparaging the minerals listed in the "all other minerals" category, we want to point out that few if any minerals are more essential to this country's future economic health than coal is. It should, as a minimum, be given the rate for "all other minerals," which under existing law is 15%. We believe that rate should not be cut; if it must be cut, then coal should be placed in that category and placed at 11%. Preferably, the entire group (including coal) should be put at 15%, because we cannot maintain our economy without the incentives to produce the minerals that make possible our housing, our automobiles, our air conditioning, and the other necessities of a modern industrial society.

The rate of percentage depletion can have an important effect on coal exports. While foreign oil is cheaper than American coal, in foreign markets, as a source of energy, the steel industries of the world must have metallurgical coal. As a consequence, we are exporting today about $500 million worth of coal per year—which the Government regards as a very important asset in the country's fight to maintain a balance of trade. At the present time, because of an unexpected upsurge in world steel production and because of a world-wide tight supply of metallurgical coal, competitive pricing is not the most significant factor in the volume of coal exports. Under normal conditions, however, the export market for metallurgical coal demands competitive pricing. Adding to the tax burden of United States coal exports will, when the current sellers' market comes to an end, handicap the coal industry in its effort to aid in the balance of payments problem through coal exports.

In addition, we urge that consideration be given to liberalization of the allowance for marginal or near-marginal mines. The limitation of the allowance to 50 percent of the taxable income from the property does not impose a burden on the highly successful mines, but it does restrict the allowance of the mines which are marginal or near-marginal from a profit standpoint.

II. *Effective date of production payment change.*

We are not objecting to the repeal of the present treatment of mineral production payments—but we do want to point out that repeal of that treatment does substantially increase the industry's tax burden and thereby increases the need for proper incentives through other features of the tax laws.

In view of the very great lapse of time between the first "notice" of intention to act on production payments (April 22, 1969) and the probable date of enactment of "tax reform" legislation, we believe the effective date of the repeal should be changed to apply only to production payments entered into after the date of enactment of the legislation—or, perhaps, after the end of the 1969 calendar year. We are not trying to defend continuation of this treatment. Nevertheless, it was a treatment that grew out of the position of the Internal Revenue Service. Our people have relied upon that position in "tax planning." Probably it should be changed. But it is not necessary to change it retroactively—and April 22, 1969, is quite "retroactive" for a bill which may become law in December or, possibly, in February of 1970.

III. *Synthetic fuels—cut-off point.*

A Committee amendment was adopted on the Floor of the House to provide that oil shale's depletion shall be computed, roughly, at that point where it is equivalent, or nearly equivalent, to crude oil. When Congressman Aspinall asked for this treatment before the Ways and Means Committee, he included in his request coal and any other minerals used to make synthetic oil and gas.

Depending primarily on import control policies, it may be many years before it is economic to make synthetic gas and oil out of other minerals—such as coal and oil shale. When it does become economic, there should be no discrimination. All the evidence indicates that our vast coal reserves will be more adaptable, from an economic standpoint, for this purpose than oil shale will be.

Any mineral used to make synthetic oil and gas should receive the same tax incentive as *any other* mineral used for the same purpose. We therefore ask you to add to the oil shale amendment a provision which will state, in substance, that:

> Equivalent in result "ordinary treatment processes" will be extended to any mineral used to make synthetic oil and gas, under regulations prescribed by the Secretary, but such treatment processes shall in no event go beyond the point where the product is equivalent in composition and value to crude oil at the well or raw gas at the well.

In testifying before this Committee, Treasury officials objected to the oil shale amendment on the ground that it would extend depletion to cover "manufacturing" activities. They stated, however, they were sympathetic to the objective of giving tax incentives to promote the production of synthetic oil from oil shale, and would attempt to come up with recommendations to accomplish this end. If the Treasury officials do recommend an alternative method of furnishing the necessary incentives, such alternative method should be made applicable to all minerals used for the same purpose.

IV. *Depreciation guidelines and the "reserve ratio" test.*

With the forthcoming repeal of the investment credit, it is imperative that Congress provide a more balanced climate for the investment of capital in new productive equipment. The Treasury Department is currently conducting a study of possible methods of accomplishing this, through depreciation revisions and other possible changes. That appears to be a long-term proposition, and we believe there are two actions which can be taken by Congress now, *without any appreciable effects on the revenue estimates for this legislation*. Those two actions are as follows:

> (a) Provide legislative sanction for the existing depreciation guidelines, simultaneously eliminating the need to meet the "reserve ratio" test.
>
> (b) Permit inclusion of "industrial buildings" within the depreciation guidelines, but provide for taxation at ordinary income rates for all depreciation taken in the future and recaptured on sale of such industrial buildings.

Several years ago the Treasury Department promulgated its shortened depreciation guidelines, to facilitate recovery of capital investment. Unfortunately, Treasury officials felt bound by statute to maintain a tie between these shortened guidelines to "useful lives," and they accomplished this by imposing an impossible, unworkable "reserve ratio" test—which, when fully effective, will limit use of the guidelines to those who actually retire their equipment in the shortened guideline periods rather than in the ordinary 'useful life" period. Former officials of the Treasury Department insisted that this "reserve ratio" test was an incentive to modernize; they contended taxpayers would discard still-useful equipment in order to be eligible for the shortened guideline lives.

We believe the view that the "reserve ratio" test is an incentive to modernize is in error, because the incentive to invest in new equipment depends on the probability of, and the timing of, return of capital. The reserve ratio test, by delaying the return of capital, reduces the incentive to invest in modern equipment and contributes to the inability of the United States to compete with the nations which give more adequate incentive for modernization.

The effect of the reserve ratio test has been postponed, administratively, to the point where it has not been felt in the past but is about to affect many taxpayers—an increasing amount each year. As it becomes effective, it not only takes away the shortened depreciation lives set forth in the guidelines, but it lengthens them beyond the actual "useful lives" to make up for the previous shortening.

The depreciation guidelines constituted an important administrative reform of depreciation—granting an incentive for investment in equipment through shorter capital recovery, and eliminating a great deal of non-productive controversy over depreciation lives. The revenue cost of that reform has already been absorbed. Legislative sanction of that reform, coupled with repeal of the reserve ratio test, will not affect the revenue estimates of the bill before you. Unless Congress takes this action, the administratively-granted reform will be eliminated—with over-compensation, increasing depreciation lives to make up for the previous shorter lives. Without Congressional action in this regard, the reserve ratio test will further retard the investment of the capital necessary to keep the economy going, and further increase the danger of a real depression.

The bill before you limits depreciation on buildings constructed after July 25, 1969, to 150% of straight-line depreciation, and treats gain on sale of buildings as ordinary income to the extent that accelerated depreciation taken in the future is in excess of straight-line depreciation. The "real estate tax shelter" does not involve industrial buildings—those buildings which house equipment which is an integral part of extraction of minerals, manufacture and distribution. Industrial buildings generally are not sold—unless an entire business is sold. At one time, when former officials of the Treasury were instituting the depreciation guidelines for personal property, they indicated they would be willing to consider shorter useful lives for industrial buildings if all gain on sale were treated as ordinary income to the extent of depreciation taken and recaptured on sale.

We believe Congress should provide for taxation at ordinary income rates with respect to all depreciation taken in the future and recovered on sale of "industrial buildings," and in return therefor Congress should permit inclusion of such industrial buildings within the guideline lives (without reserve ratio test) provided for the industries in which such buildings are involved.

V. *Multiple corporations.*

The House bill phases out the use of "multiple corporations." We can and do understand the objective—where a business is split into 50 or 200 corporations for purposes of tax savings, something should be done about it. But there are many situations where multiple, or separate, corporations are required for sound business reasons (other than tax savings). We ask that you retain the present tax treatment of multiple corporations where the taxpayer can demonstrate that there is a sound business reason (independent of and apart from tax savings) for the use of multiple corporations.

VI. *Mineral exploration expenditures.*

Under existing law, many small companies and individuals engaged in the mining industry have elected Section 615, which allows a total of $400,000 exploration expenditures to be deducted without subsequent recapture of the tax benefit. However, after they reach the $400,000 level they are not allowed to take any further deductions. The larger companies have, by and large, elected Section 617, which permits them to deduct exploration expenditures without limitation but subject to "recapture" of the tax benefit if the exploration is successful.

Under the bill as passed by the House, the small companies which elected Section 615 are made subject to "recapture." However, the limitation on their deductions has not been removed. It should be removed, so that 615 taxpayers will be treated the same as 617 taxpayers. We understand this was a legislative oversight and that it will be corrected.

We appreciate the opportunity to present our views to the Committee.

[From Business Week, July 5, 1969]

The Coal Bin Is Running Short

A combination of recurrent strikes in the nation's bituminous coal fields and steadily rising demand for U.S. coal is now beginning to threaten coal supplies for some basic U.S. industries. This week, with production in the year's first half about 16-million tons lower than 1968's first half, thousands of miners began their annual two-week vacation. Their mood was so volatile that nobody could be sure of when they would return to work.

While output dropped demand increased. The National Coal Assn., the coal operators' trade group, last week forecast that demand this year would be 16-million tons above last year's consumption of 549.5-million tons—up as much as the half-year's output was down. "These are the most aggravated shortages we've had since the Suez crisis of 1957," says William Bellano, president of Island Creek Coal Co., third-ranked U.S. producer.

RUNNING LOW

As of now, the main impact of shortage seems to fall on domestic steelmakers. Unable to buy all the coking coal they need for blast furnaces, they are wrestling with what one steel official calls a "hand-to-mouth situation." Metallurgical coal stocks, as of May 1, constituted a 32-day supply (35 to 50 days is normal). But one large steel producer says that if there were a mine walkout of three weeks or so in the next two months, blast furnace operations would have to be curtailed. Another says even a two-week strike could put steel in such a bind it might possibly ask for government help.

Foreign steel producers, notably the Japanese, have increased their demands for U.S. low-sulfur, metallurgical coal. Since air pollution codes are also forcing other domestic coal users into the low-sulfur market—and only 20% of all coal mined is low-sulfur (1.5% or less sulfur content)—an acute shortage has developed in this category.

Meanwhile, coal inventories at electric utilities have decreased from the normal 90-day supply to less than 80. This is not unusually low, says the U.S. Bureau of Mines, and the utilities contend they have plenty of coal. But coal industry officials insist that if production-losing strikes coincide with summertime's peak power demands, some coal-fired power stations might be forced to schedule "brownouts," or temporary power reductions.

STRIKES

Most of this year's drop in production is attributed to work stoppages, such as the strike that closed West Virginia mines (which produce 30% of U.S. coal) for three weeks in February and March. The walkout forced passage of a state compensation law for black lung, coal workers' pneumoconiosis, a disease associated with the inhalation of coal dust. There have been slowdowns and wildcat strikes for many other reasons.

"There's a general unrest stemming from the black lung problem, as well as disappointment with last year's contract," says Otes Bennett, Jr., president of North American Coal Corp. "It worse than I've ever seen it." North American, which has no West Virginia mines, says it lost 300,000 tons of production this year because of wildcats.

Now reports are boiling up from the coal fields that miners will simply stay off the job at the end of their vacations, to dramatize their health and safety demands. In any case, unrest is certain to continue, and most industry and union sources predict further strikes.

Legislators and coal operators have a record of long inaction on miners' problems. So miners are now convinced that only by agitation will they gain a strong federal coal mine health and safety act. Bills are pending in the labor committees of both houses of Congress—and rank-and-filers in the United Mine Workers led by union dissidents and sparked by crusader Ralph Nader and other critics of the UMW leadership, will be staging rallies, marches, and possibly strikes to push for the strongest possible legislation.

Furthermore, a power struggle between UMW President W. A. (Tony) Boyle and his challenger, executive board member Joseph (Jock) Yablonski, may erupt into wilder strife inside the union before next December's election. "I expect sporadic striking to continue in the industry till after the union election in December," says Island Creek's Bellano. "We don't see any evidence that either the international union or the district union offices have got the miners under control."

MORE NEEDED

But if labor unrest explains part of the shortage, it doesn't account for all of it. U.S. productive capacity simply has not kept pace wiht expanding demand in several sectors:

Electrical utilities, which last year consumed 54% of U.S.-mined coal, have increased their demands because of delay in bringing new nuclear-powered generating stations on line.

Foreign steelmakers, especially the Japanese, are rapidly increasing their demands for low-sulfur coal.

When demand began to rise in the mid-1960s—after a decade of shrinking coal markets—the operators didn't want to invest in costly new mines unless a utility would sign a 20-year or 30-year contract for the mine's entire output.

And many utilities underestimated their coal needs because they expected the nuclear power boom to develop faster than it has.

Meanwhile, the low-sulfur coal market is extremely tight because of the new air pollution regulations aimed at cutting the amount of sulfur dioxide spewed into the air by coal-fired boilers. In St. Louis, for instance, many industrial users are unable to buy low-sulfur coal in order to meet new state regulations. And last week Chicago postponed for a year a regulation limiting coal use to 2.5% sulfur coal, because there isn't much low-sulfur coal mined near Chicago.

COAL WAR

The largest low-sulfur coal fields are the Pocahontas fields, in Virginia and southern West Virginia. Almost the entire output of this coal is tied up by utilities with long-term contracts, by U.S. steelmakers, and by the Japanese. The Pocahontas fields are also the largest source of low-sulfur, low-volatile coal for steelmaking; the best coke for blast furnaces is made by blending low-volatile and high-volatile coal.

Japanese steel producers boosted their demands for U.S. coal from 7.8-million tons in 1966 to 15.8-million last year, most of it low-volatile coal. Then, this year, they markedly increased their demands for high-volatile coal.

Though not all coal executives agree, one official of a large company contends that the heavy Japanese demand is upsetting price relationships. "The Japanese are offering more money than the domestic steelmakers. And this is having a disruptive effect on prices."

UPTIGHT

The Japanese, air pollution regulations, the needs of electric utilities, and the demands of the UMW's rank and file must, at times, seem to be closing in on a steelmaker such as, for example, Armco Steel Corp.

Armco owns some "captive" mines, but it must buy about 20% of its high-volatile and all of its low-volatile coal from outside mines. It has built up its inventories somewhat for the mines' vacation period. But "if we had a series of work stoppages, and we had to buy some coal on a spot basis," says an Armco executive, "we might find the supply very tight."

The CHAIRMAN. The next witness is Mr. John R. Greenlee, chairman of the Tax Committee, American Iron Ore Association.

STATEMENT OF JOHN R. GREENLEE, CHAIRMAN OF THE TAX COMMITTEE, AMERICAN IRON ORE ASSOCIATION

Mr. GREENLEE. Thank you, Mr. Chairman.

I am the director of taxes of the Hanna Mining Co. I appear here today in my capacity as chairman of the Tax Committee of the American Iron Ore Association.

Our association is a trade association representing companies which mine over 94 percent of the iron ore produced in the United States and in Canada. We have collaborated in the preparation of and we concur with the statement that has just been presented to you by the American Mining Congress.

We will therefore limit our testimony to certain provisions of the House bill as they specifically affect the iron ore mining industry.

Our statement, which has been filed for the record, summarizes the history of depletion, making reference to discovery value which is the bridge between cost and percentage depletion. Discovery value is based on the capital value credit rather than the cost of finding a deposit. Percentage depletion, when introduced in the Code, was calculated to allow roughly the same amount of depletion as had been realized under discovery value, but with substantially fewer administrative problems.

I would like to emphasize that in addition to operating under the economic laws which hold for all other industries the natural resource industries face at least three particular factors that distinguish it from other types of businesses.

First, we must recognize the irregularity of the distribution of mineral deposits.

We have to take into account the very high risk of exploration and development.

Third, we cannot forget the exhaustability of the capital assets without a reasonable manner of replacement.

The percentage depletion rate of 15 percent on domestic iron ore as set forth in the House bill should be retained. There is equal validity for maintaining the 15-percent rate for foreign iron ore deposits.

In light of the operation of the foreign tax credit provisions the denial of full depletion on foreign iron ore would result in the U.S. taxpayer paying additional tax to foreign countries with probably no additional tax to the United States.

For almost 40 years percentage depletion has been and continues to be a very important factor in the maintaining of decisions to expend money on iron ore in order to maintain a viable healthy iron ore mining industry, and the basic steel industry which it supports. It is absolutely essential to the security of our Nation.

Why is the iron ore industry unique? Iron ore processing plants today require an average investment in the order of magnitude of $150,000 per employee, and this compares to an average of $19,000 per employee for the top 500 industrial companies in the United States as listed by Fortune magazine. Each million tons of capacity in our industry now requires an investment of at least $35 million.

Since 1954 the iron ore industry has invested $2½ billion in mining facilities. The industry faces enormous capital investment programs in the future to provide for our ever-increasing needs and to provide for the needs for an expanding domestic steel industry.

Fundamentally these capital funds can be obtained only by attracting new investment or by retaining profits in the business. Both of these sources exist only if there is an adequate return on investment in the iron ore mining industry.

Let me move now to the foreign tax credit provisions of the House bill.

Senator GORE. Mr. Chairman, may I ask one question right here?

Mr. GREENLEE. Yes, sir.

Senator GORE. With respect to return on investment, as I understand it, all mineral royalties are treated as normal income except in the case of iron ore royalties. Why on earth should iron ore royalties be treated as capital gain income?

Mr. GREENLEE. Senator Gore, you may or may not recall, but we filed a statement with this committee when that subject was enacted into law. Our Association opposed the treatment of iron ore royalties in the hands of lessors. We opposed the capital gain treatment, because of our concern about the right of the operator to an ordinary deduction of this expense.

Senator GORE. You still stand that way?

Mr. GREENLEE. Sir?

Senator GORE. You still take that position?

Mr. GREENLEE. We still take that position, yes, sir.

Senator GORE. Thank you, Mr. Chairman.

Mr. GREENLEE. Yes, sir.

Senator MILLER. May I ask a question?

Do you know about how much the annual depletion amounts to in your industry?

Mr. GREENLEE. Senator Miller, I do not have that information. I just do not know and I do not know how to get at it.

Senator MILLER. Could you give us an estimate? You do not have to do it right now.

Mr. GREENLEE. Surely.

Senator MILLER. I have two questions.

Mr. GREENLEE. Yes, sir.

Senator MILLER. No. 1, what is the estimated annual depletion deduction within your industry, and No. 2, what is the estimated annual expenditure for exploration, research and development for your industry?

Mr. GREENLEE. Senator, we will be glad to try to get that information for you and submit it to you, yes sir.

Senator MILLER. Thank you.

(The following was subsequently submitted for the record:)

AMERICAN IRON ORE ASSOCIATION,
Cleveland, Ohio, October 10, 1969.

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

DEAR SENATOR LONG: On September 30, 1969 during our appearance before the Senate Committee on Finance, we were asked by Senator J. Miller to submit answers to the following two questions for the record:

1. What is the amount of the annual depletion deduction for the iron ore mining industry; and
2. What is the amount of the annual exploration expenditures for the iron ore mining industry?

Reference is made to Part I of the record of Hearings before the Committee on Ways and Means, House of Representatives Eighty-eight Congress, First Session on The Tax Recommendations of the President contained in his message transmitted to the Congress on January 24, 1963. Exhibit 10, dated February 6, 1963 beginning on page 290 of that record makes reference to a survey of the depletion deductions and the exploration and development expenditures by mineral product types and by foreign and domestic properties. The latest group of years included in this survey covered 1958, 1959, and 1960 and preliminary tabulations of that survey were included in the record. The Treasury pointed out that total depletion by type of mineral is not available in the Statistics of Income published by the Treasury and that the survey was undertaken to approximate the depletion total for various mineral categories for these years. This effort was necessarily a sample survey.

To my knowledge, there are no available figures of more recent date that would indicate the amount of the annual depletion deduction and the amount of the annual expendiutres for exploration in the iron ore mining industry. This Association has never, in its long history, collected information of this nature and it would be difficult, if not impossible, to compile such information at this time.

The problem with respect to exploration expenditures is further complicated by the fact that, until Section 617 was enacted into the Internal Revenue Code in 1966, taxpayers were limited to a total amount of $100,000.00 per taxpayer as a deduction for exploration expenditures. Therefore up until that time (1966) there existed no relationship in the iron ore mining industry between annual expenditures for exploration and the deductions allowed.

We sincerely regret that we are unable to furnish the information which was requested by Senator Miller at the recent hearings.

Sincerely,

JOHN R. GREENLEE,
Chairman, Tax Comittee.

Mr. Greenlee. If I may I will continue with the discussion of the foreign tax credit provision.

The present existence of the OFDI rules makes even more important the position we take with respect to the provisions of the foreign tax credit as they exist in the House bill. The extractive industries we think should not be singled out for adverse treatment in the computation of the foreign tax credit. Sections 431 and 432 of H.R. 13270, as they are drafted, miss the point of the foreign tax credit and should be rejected.

The United States historically has predicted its taxation philosophy on the pattern of applying the income tax to all United States citizens on a world-wide basis regardless of residency or souce of income. The U.S. citizen is also taxed by most foreign countries on income arising from sources within their respective borders regardless of his U.S. citizenship.

Without these foreign tax credit provisions, the resulting double taxation of foreign source income would render foreign operations competitively impossible.

The use of the foreign tax credit has been a cardinal part of our law almost from the inception of the initial Income Tax Act. Adequate world-wide long-term reserves of iron ore must be maintained under the control of United States based companies for the economic well-being of our country. It is, therefore, essential to adopt and maintain tax policies which encourage domestic producers to seek the raw materials available for U.S. consumption, regardless of where these raw materials are found.

I would like now to turn to the provisions with respect to the depreciation of real estate. The proposed repeal of the investment credit provisions of the Code brings into sharper focus the restrictive provisions of section 521(a) of the House bill which denies the use of double declining balance or the sum of a year's digits method to new depreciable real property other than residential housing.

Depreciable industrial real estate constructed or acquired for the taxpayer's own use should not be denied the use of accelerated depreciation.

I want to emphasize when making this point that we do not oppose the full recapture provisions as they might be applied to real estate.

In conclusion, I point out that our strong feeling is that the necessity for long-range planning in the iron ore mining industry and the related necessity to consummate long-range financial commitments require reliance on tax grouped rules that exist at the time such commitments must be made. That alone we think makes a strong case for the premise that any change in legislation ought to reflect the fundamental rule of fair play that taxpayers are entitled to the fulfillment of reasonable certainty in their choices of business and investment arrangements.

In conclusion, we therefore strongly urge that the depletion rate for iron ore be retained at 15 percent for both domestic and foreign production. We urge that the present rules with respect to the computation of the foreign tax credit be retained, and the provisions of the House bill relating to this subject be rejected.

We also state that the present accelerated depreciation provisions as they relate to industrial real property should be retained, and section 521(a) of the House bill should be rejected.

Thank you very much.

The CHAIRMAN. It would seem to me from your statement that you are speaking for those who mine iron ore and not for those who own the land.

Mr. GREENLEE. You are entirely correct. We are talking from the standpoint of those who operate the mines.

The CHAIRMAN. Thank you very much.

Mr. GREENLEE. Thank you; sir.

(John R. Greenlee's prepared statement follows:)

STATEMENT OF JOHN R. GREENLEE, CHAIRMAN OF THE TAX COMMITTEE, AMERICAN IRON ORE ASSOCIATION

SUMMARY

Introduction

The American Iron Ore Association endorses statement of American Mining Congress and limits testimony to Sections 431, 432, 501 and 521 of HR 13270 as those sections specifically affect iron ore mining industry.

History

History of depletion traced. Bridge between cost and percentage depletion discussed.

Percentage depletion rates

The depletion rate for iron ore should be retained at 15% for domestic production as provided for in HR 13270. We also believe 15% should be retained for foreign production and we explain this under our discussion on Foreign Tax Credit.

Economic factors and national securiyt

A viable, healthy iron ore mining industry is essential to security of nation. Enormous capital investment has been made by the industry and vast sums will be required in the future to provide the necessary iron ore to maintain our present standard of living. It is necessary to maintain adequate return on investment in iron ore mining industry in order to provide future capital requirements.

Foreign tax credit

Extractive industries should not be singled out for adverse treatment in computation of foreign tax credit. Present rules with respect to computation of foreign tax credit should be retained and the provisions of HR 13270 relating to this subject should be rejected.

Real estate depreciation

Depreciable industrial real estate constructed or acquired for taxpayer's own use should not be denied the use of accelerated depreciation. Section 521(a) of HR 13270 should be rejected.

Conclusion

The necessity for long range planning in the iron ore mining industry and the requirement for long range financial commitments makes a strong case for the premise that changes in legislation should reflect a fundamental rule of fair play that taxpayers are entitled to reasonable certainty in making choices of business and investment arrangements.

STATEMENT

My name is John R. Greenlee. I am the Director of Taxes of the Hanna Mining Company, Cleveland, Ohio.

I welcome and appreciate this opportunity to appear before you today in my capacity as chairman of the Tax Committee of the American Iron Ore Association. The American Iron Ore Association is a trade association representing companies which mine over 94% of the iron ore produced in the United States and Canada. The Association headquarters is located at 600 Bulkley Building, in Cleveland, Ohio.

CONTENTS

The American Iron Ore Association limits its presentation to a discussion of percentage depletion and the importance of percentage depletion to the iron ore mining industry and the Nation; a discussion of Sections 431 and 432 of HR 13270 dealing with the computation of the foreign tax credit; and Section 521 of HR 13270 affecting the depreciation of real estate. The statement consists of seven parts, namely:

1. Introduction.
2. History.
3. Percentage Depletion Rates.
4. Economic Factors and National Security.
5. Foreign Tax Credit.
6. Real Estate Depreciation.
7. Conclusion.

INTRODUCTION

Our testimony today will deal with Sections 431, 432, 501, and 521 of HR 13270 as passed by the House of Representatives on August 7, 1969. Sections 431 and 432 of that bill affect the computation of the credit for foreign taxes, Section 501 is concerned with the taxation of income derived from the mining of natural resources, and Section 521 deals with the depreciation of real estate. We have purposely limited our discussion to the application of these provisions as these proposed changes affect the iron ore mining industry.

We have collaborated with the American Mining Congress in the preparation of the statement presented to your Committee by them and concur with it. We wish to add however, certain points that have particular reference to the iron ore mining industry.

HISTORY

The statement of the American Mining Congress has traced the development of the legislative history of percentage depletion in some detail which we will not repeat. We would add to that history the following additional facts.

In the early years of the income tax, depletion was based on what the taxpayer had paid for the acquisition of the mineral deposit. This was Cost Depletion which is still a part of the law today. Between cost and percentage depletion, which first became a part of the law in 1926, came Discovery Value Depletion. This method is the "missing link" which connects the original cost depletion with percentage depletion. What discovery value depletion sought to do was to allow depletion to be based on the value of the deposit rather than the cost of acquiring it, i.e., the *capital value* created, rather than the *cost* of its creation.

Because of the many difficulties encountered in administration, discovery value gave way to percentage depletion. Percentage depletion represented an effort to allow roughly the same amount of depletion as had been realized under discovery value. Discovery value, as stated earlier, was enacted to prevent the taxation of the capital value created. Percentage depletion was introduced to present similar results but with substantially fewer administrative problems. It again recognized that an equitable tax system must and should take into account the capital value of mineral resources and exclude such value from a tax on income. This is a fact that seems to be lost in the discussions of percentage depletion in the tax reform movement.

We emphasize one fact which we think is not generally understood. Mineral industries must operate, not only under economic laws which hold for other industries, but also under conditions which hold *only* for the mineral industry. There are at least three principal factors that distinguish the mineral industry from other types of business:

1. The irregular distribution of mineral deposits;
2. The high risk of exploration and development; and
3. The exhaustibility of the capital assets without a reasonable manner of replacement.

Certain provisions of the Internal Revenue Code were developed to recognize the unique position of the mineral industries and were inserted into the law for sound and thoroughly considered reasons. They have been reviewed periodically and have been found on a continuing basis to fulfill the purpose and need for which they were originally enacted.

PERCENTAGE DEPLETION RATES

The percentage depletion rate of 15% on domestic iron ore as set forth in the House Bill should be retained for the reasons stated under the caption "Economic Factors and National Security". There is equal validity for maintaining the 15% rate for foreign iron ore deposits for the reasons later discussed under the caption "Foreign Tax Credit". Most importantly, in light of the operation of the foreign tax credit provisions, the denial of full depletion on foreign deposits would result in the U.S. taxpayer paying additional tax to the foreign countries and no additional tax to the United States. No reasonable distinction can be made between domestic and foreign depletion rates as applied to the production of iron ore and we therefore strongly urge that both remain at 15%.

ECONOMIC FACTORS AND NATIONAL SECURITY

A viable, healthy iron ore mining industry (and the industry it supports—the basic steel industry) is absolutely essential to the security of our nation.

For almost forty years, percentage depletion has been and continues to be an important factor in the making of decisions to expend money on mining as compared to other investment opportunities.

What makes the iron ore mining industry unique? Never before in the history of that industry has capital in such enormous amounts been so requisite to survival in the industry. Plants to process the present reserves of iron ore in order to make them acceptable in the current market require tremendous capital investments. For example, the top 500 industrial companies in the United States, as listed by Fortune magazine, require an average investment of $19,000 per employee, whereas iron ore processing plants today require an investment in the order of $150,000 per employee. A capital investment of at least $35 million is needed for each million tons of annual capacity. Since 1954 the iron ore industry has invested $2.5 billion in mining facilities. The industry faces an even larger capital investment program in future years to provide for the expanding needs of our domestic steel industry.

The enormous future capital requirements of the iron ore mining industry may be illustrated by a quote from a recent book, "Affluence in Jeopardy" written by Charles F. Park, Jr., Professor of Geology and of Mineral Engineering at Stanford University:

"In the year 1967 the per capita consumption (of iron) in the United States was about one ton per year; a comparable world figure was 0.17 ton per person. To double the population of the world by the year 2000 and simply to maintain the same per capita consumption of iron means doubling its production, i.e., producing about 550 million more tons annually. Should the present population of the world raise its consumption of 0.17 tons per year to that of the United States, then 3.25 billion tons, or an increase to 6 times our present production, would be required annually. In the event that the population of 6½ billion people in the year 2000 will require one ton per person per year, as we in the United States now do, then the current annual production of 550 million tons would have to be increased 12 times. Such figures clearly show the difficulties inherent in supplying man with the amounts of iron he needs if he continues to expand numerically at the projected rate. Such figures allow for no greater per capita use of iron and steel than that of the United States today, and yet even here people are hoping for higher standards of living that will require greater per capita consumption of both."

Where are these capital funds to be obtained? Fundamentally, capital funds can be obtained only by (1) attracting new investment, or (2) by retaining profits in the business. Both of these sources exist only if there is an adequate return on investment in the iron ore mining industry.

FOREIGN TAX CREDIT

The American Iron Ore Association strongly urges that the present rules for the computation of the foreign tax credit be retained. Sections 431 and 432 of HR 13270 as drafted miss the point of the foreign tax credit. In attempting to eliminate a possible "double benefit" these sections of the House Bill do violence to other sections of the code and should be rejected.

From the enactment of the first income tax law in 1913 the taxation philosophy of the United States has been predicated on the pattern of applying the income tax to all United States citizens on a world-wide basis regardless of residency or source of income. The U.S. citizen is also taxed by most foreign countries on income arising from sources within their respective borders regardless of his U.S. citizenship. Without these foreign tax credit provisions the resulting double taxation of foreign source income would render foreign operations competitively impossible. As a result, almost from the inception of the initial income tax act the device of the foreign tax credit has been a cardinal part of our law. This concept is generally followed for all business operations and is *not applicable exclusively to mineral operations*. The extractive industries should not be singled out for adverse treatment.

Any restrictive changes in the computation of the foreign tax credit should particularly be avoided while the present extremely difficult repatriation rules are being imposed by the Office of Direct Foreign Investment.

Adequate world-wide, long-term reserves of iron ores must be maintained under the control of United States based corporations for the economic well-being of our country. It is essential therefore, to adopt tax policies which encourage domestic producers to seek the raw materials available for U.S. consumption regardless of where these raw materials are found. To do otherwise would result in the development of these additional sources of raw materials by non-nationals who may or may not be concerned with the best interest of the national defense of the United States and the economic well-being of its iron and steel industry. Therefore the encouragement of American companies to secure mineral rights in foreign countries is essential from the standpoint of the continued economic growth of our country.

The present proposals adversely affect our international competitive position. American capital must develop foreign iron ore reserves, not only to complement our domestic supplies but in order that United States controlled operations can effectively compete in the foreign markets for iron ore.

Since foreign income taxes paid by U.S. companies are allowed as credits against U.S. income taxes otherwise payable, the tendency of mineral producing countries is to raise their income taxes at least to a level that will absorb the full allowable credits. Thus any increase in the U.S. effective tax rate would not be likely to increase U.S. tax revenues. This might, however, increase foreign revenues with adverse effect on U.S. balance of payments and with resulting tax disadvantage to U.S. Companies in comparison with their foreign competitors in world markets. This is particularly true with respect to iron ore operations in Canada.

Apart from these considerations, however, Section 431 of the House Bill provides for recapture of foreign tax credit even in cases where no U.S. tax benefit was ever received, and Section 432 imposes foreign tax credit limitations in cases where the foreign government has an ownership position in minerals even though mining companies may pay foreign income taxes at a lesser effective rate than other corporate taxpayers generally. These provisions should be rejected.

REAL ESTATE DEPRECIATION

Section 521(a) of the House Bill denies the use of the double declining balance or the sum of the years-digits methods to new depreciable real property (other than residential housing). The bill would also limit depreciation of used property to the straight-line method. This would result in a serious impact on the cash flow of the iron ore mining industry.

These provisions are broad enough in scope to include depreciable industrial real estate constructed or acquired for use as an integral part of a mining operation. There can be no relationship between the use of such industrial property and the use of certain non-industrial real property which would require a change in the depreciation of real estate. Thus, the reasons set forth in the report of the Committee on Ways and Means are inapplicable to this industry and the industry that it supports, i.e., steel.

Opportunities for tax avoidance which the Committee's action seeks to eliminate do not exist with respect to depreciable real estate used in the iron ore mining industry. We do not oppose the recapture provisions in the bill—these provisions provide ample protection against so-called abuses in this area. A mine building or a beneficiation plant constructed or acquired for the taxpayer's own use should not be denied the use of accelerated depreciation. The restrictive provisions are even more important in light of the proposed repeal of the investment credit.

CONCLUSION

The necessity for long-range planning presents particular problems in the iron ore mining industry. Correlative to this problem and necessary to its solution are long-range financial commitments. In consummating such financial commitments taxpayers must rely on tax ground rules that exist at the time the commitment is made. Any change in legislation—irrespective of its merit—ought to reflect a fundamental rule of fair play that taxpayers are entitled to the fulfillment of reasonable certainty in their choices of business and investment arrangements. A persuasive argument on this ground alone can be made to leave the rules as they are.

In summary, therefore, we strongly urge that:

1. The depletion rate for iron ore be retained at 15% for both domestic and foreign production;
2. The present rules with respect to the computation of the foreign tax credit be retained and the provisions of HR 13270 relating to this subject be rejected; and
3. The present accelerated depreciation provisions as they relate to industrial real property should be retained and Section 521(a) of HR 13270 should be rejected.

The CHAIRMAN. Now, the next witness will be Mr. Kenneth E. Tobin, Jr., managing director of the National Industrial Sand Association and managing director of the National Sand & Gravel Association.

STATEMENT OF KENNETH E. TOBIN, JR., MANAGING DIRECTOR, NATIONAL INDUSTRIAL SAND ASSOCIATION, AND MANAGING DIRECTOR, NATIONAL SAND & GRAVEL ASSOCIATION; ACCOMPANIED BY CHARLES E. BRADY, SALISBURY, N.C., AND EARLE T. ANDREWS, A MEMBER OF THE TAXATION COMMITTEE OF THE NATIONAL INDUSTRIAL SAND ASSOCIATION, SILVER SPRING, MD.

Mr. TOBIN. My name is Kenneth Tobin. I am the managing director of the National Sand & Gravel Association and the National Industrial Sand Association.

With your permission, Mr. Chairman, I would like to divide the time which you have been so kind enough to allot us this morning between Mr. Charles E. Brady of Salisbury, N.C., who would like to present a statement in behalf of the sand and gravel industry of the United States and Mr. Earle T. Andrews of Berkeley Springs, W. Va., who would like to present a statement in behalf of the industrial sand industry of the United States.

Mr. BRADY. Mr. Chairman and members of the committee, my name is Charles E. Brady, and I am president of Material Sales Co. of Salisbury, N.C., a sand and gravel sales organization.

I am also the immediate past president of the National Sand & Gravel Association, and presently chairman of its taxation committee.

Sand and gravel is the basic building material. It is employed in every type of construction, both public and private. Sand and gravel nevertheless is not an inexhaustible natural resource. The very opposite is the fact: In the latest statistical study of sand and gravel reserves in 1963, the National Sand & Gravel Association found that currently held reserves had a life expectancy of only 24 years.

According to the demand estimates of the Bureau of Mines, our industry must produce approximately 66 million tons of sand and gravel between 1970 and the year 2000. Our last year's recordbreaking production was 918 million tons valued at over $1 billion. Now, where in the world is our industry going to find the deposits to produce so much sand and gravel in these 30 years?

Our industry is privately owned and financed in the best American tradition of free enterprise. If we are to continue to explore for and acquire needed additional reserves, in these times of escalating land costs, restrictive zoning codes, and competition from other sources for the use of land containing sand and gravel deposits, we need as never before our modest 5 percent depletion.

I urge you to allow our industry to continue receiving this 5 percent allowance, which it needs to remain healthy. I thank you.

Mr. ANDREWS. Mr. Chairman, gentlemen, my name is Earle T. Andrews. I am a member of the National Industrial Sand Association's Tax Committee and am Chairman of the Board of the Pennsylvania Glass Sand Corporation. With your permission I will read hastily from notes in the interests of conserving your time.

The National Industrial Sand Association is an industry association representing approximately 85 percent of the production of industrial sands in the United States. Industrial sand is a general term for quartzite and also quartz sand and pebbles used or sold for purposes dependent upon their silica content or their chemical or refractory properties.

Industrial sand is a primary raw material used in the manufacture of glass, chemicals, electrical porcelains and other silica based products and as metallurgical sand required in the manufacture of ferrous and nonferrous metal products. These constitute the primary markets although there are over 100 industrial and technical commercial uses requiring the unique chemical and physical properties of industrial sand. We submit that the conclusions of the Ways and Means Committee were not based upon any study of the industrial sand industry or the mining industry generally.

Mineral resources are a wasting asset and percentage depletion recognizes this fundamental reality. Presently available mineral deposits are gradually being exhausted and additional reserves must be found and maintained.

Percentage depletion of the national mineral policy generally has fostered the development of this country's natural mineral resources which is in turn tied directly to the Nation's economic growth.

Tax reform is intended to eliminate inequities and redistribute the burdens of taxation or to simplify the assessment of reliability, but it should not reverse unintentionally the national minerals policy.

Industrial sand is a small industry. As reported by the Department of the Interior, total production of industrial sand in 1967 amounted to 25,323,000 short tons, valued at $85,555,000. The amount of the aggregate depletion deduction for industrial sand is not available.

The total value of the industry's production establishes that the proposed rate reduction will not increase the Nation's revenues substantially. Individual producers of industrial sand will be confronted by a sharp cut-back of almost 27 percent in their allowable depletion deduction.

Percentage depletion has become an integral part of the economics of the industrial sand industry. The proposal rate reduction would be a serious dislocation. Prices would need to be raised substantially to offset the lower depletion deductions.

The impact of the rate reductions is not likely to be overcome satisfactorily by price increase, and the likely consequences include curtailed exploration and development of new deposits, less research into mineral recovery methods, and slower modernization of operating methods. Adequate supplies of industrial sand are not easily located, developed or processed into marketable levels of purity.

Extensive exploration development and sophisticated and expensive processing of the material are required to meet today's demands much less the increasing needs of the future.

The conclusion must be drawn that the proposed percentage depletion rate reduction will affect the capital values, the risk element of industrial sand producers which in turn will adversely affect the supply of this important material.

The other provisions of the House bill applicable to all businesses serve whatever may be the reasonable demands of tax reform on the mining industry.

I thank you and I will endeavor to answer any questions submitted.

The CHAIRMAN. Let me ask one question. To what extent does the cost of washing the sand or cleaning up the sand and gravel raise the depletion allowance from the value of the sand or gravel in place?

It is of very little value where you find it, but you have to wash the gravel, for example. How much does that raise the depletion allowance? It is 5 percent but 5 percent of what?

Mr. ANDREWS. Well, let me answer it this way. First, the industrial sand industry is not engaged in the production of sand and gravel per se. I think you understand this.

Second, we extract an ore from the ground which has the basic crystalline silica content. In this aggregate ore we extract from the ground there are other mineral impurities, coatings on the grain or discrete parts of other minerals and these have to be extracted by processing. Some of this is done by repeated washing. In other cases more solphisticated methods are applied.

But the major part of the cost really accrues in this processing. The material as you extract it from the ground has no commercial value per se. You cannot sell it in that condition.

The CHAIRMAN. I was just trying to determine to what extent that increased the value. It is zero when you extract it from the ground. What is the worth of it by the time you get through washing?

Mr. ANDREWS. Well, the average sales price of industrial sand, for instance, varies from approximately $3 to $4 a ton. Its price as you extract it from the ground would be simply an estimate but it is not sold in that condition. It is not in a marketable state. Just one other statement, Senator, industrial sand and construction sand are two complete and separate entities. They are not interchangeable. They both have certain illogical characteristics. They are not interchangeable. They do not go through the same processing methods. They are mutually exclusive as far as the market is concerned. Thank you.

Senator MILLER. What is estimated total annual amount of depletion—for tax purposes—in your industry?

Mr. ANDREWS. I can only give an intelligent estimate. The depletion allowance for the industry is probably between $11 million and $13 million and the tax benefit therefrom between $5,500,000 and $6,500,000.

Senator MILLER. What is amount of total gross sales of your industry?

Mr. ANDREWS. United States Bureau of Mines statistics show $85,855,000 as the value of the production of our industry for 1967. I would estimate sales of industrial sand for 1969 would approximate $93 million.

Senator MILLER. Thank you, sir.

The CHAIRMAN. Thank you very much, gentlemen.

(Charles E. Brady and Earle T. Andrews' prepared statements follow:)

STATEMENT OF CHARLES E. BRADY, NATIONAL SAND AND GRAVEL ASSOCIATION

SUMMARY

The sand and gravel industry, according to the U.S. Bureau of Mines, is the largest non-fuel mineral industry in the United States and the demand for sand and gravel "is greater than the combined demand for the rest of the non-fuel non-metallic minerals."

In 1968 our industry produced 918-million tons of sand and gravel. According to the Bureau of Mines, the country's need for sand and gravel of suitable quality between 1970 and 2000 will necessitate production of almost 60-billion tons—a staggering figure! To meet this demand for sand and gravel, the basic construction material, we must on the average double our record-breaking 1968 production in each of those 30 years.

Ours is a privately owned and managed small-business industry, making available in every area of the United States a valuable and essential natural resource, without which this country could not fight a war, prepare for the possibility of another war, maintain this country's high standard of living, and make it possible to undertake a program for urban development and housing on a large scale to accommodate the predicted increase of 100-million people in the metropolitan areas by 1992.

Sand and gravel is not an inexhaustible natural resource. There is a widespread assumption in this country that the availability of sand and gravel is unlimited. The very opposite is the fact: in the latest statistical study of sand and gravel reserves conducted by the Association, in 1963, it was estimated then that, on a national average, currently-held reserves had a life expectancy of 24 years. This estimate was based on an annual rate of production which has substantially increased since 1963 and which all forecasts predict will further increase dramatically. Additionally, the average life expectancy of reserve deposits is substantially less in major metropolitan areas where the demand for sand and gravel is the highest.

One day our country will surely discover that the largest member of the mining family is being driven farther and farther away from its point of use and that, therefore, the cost of construction of all types will be substantially increased, because transportation costs are the dominating factor in sand and gravel prices.

Land costs for sand and gravel deposits have risen alarmingly in the last 15 years. These costs will increase, thus aggravating a problem which is more serious in the case of the sand and gravel industry than in any other natural resource industry. Since sand and gravel operations must be located close to the metropolitan areas which provide our principal markets, our industry must pay many times the price for land paid by other natural resource industries. Without a percentage depletion allowance of at least 5 per cent, we will not be able to locate and acquire the land which is necessary to produce the sand and gravel which the country must have in order to sustain its building and construction program.

No other mining industry is so widely dispersed as our industry. Our operations are found in every state of the Union. The modest 5 per cent depletion allowance for sand and gravel has been indispensable to our industry in meeting the heavy capital charges involved in locating and obtaining sand and gravel deposits of the necessary quality and reasonably close to the metropolitan areas which are our principal markets. I have described our 5 per cent depletion allowance as modest. It is! Its continuation is necessary if our industry is going to be able to turn out the billions of tons of sand and gravel which we will be called upon to produce in the years ahead.

STATEMENT

My name is Charles E. Brady. I am Chairman of the Committee on Taxation and past-President of the National Sand and Gravel Association. I am also President of the Material Sales Company, Salisbury, North Carolina. I appreciate the opportunity afforded me by our Committee to speak for the sand and gravel industry of the United States in asking your Committee to continue the present percentage depletion rate of 5 percent for the sand and gravel industry, which the House of Representatives would reduce by 20 percent to 4 percent.

It should be noted at the outset that no public official or any private agency has ever at any time criticized or made objection to the 5 percent rate for the sand and gravel industry, authorized by the Congress in 1951. The House Ways and Means Committee did not give us an opportunity to be heard before it made its recommendation to the House. I have no doubt that many members of the House, had it not been for the closed rule under which the bill was considered, would have voted against the reduction in our modest percentage depletion allowance, had there been an opportunity to do so.

It seems quite obvious that the across-the-board reductions in the percentage depletion allowance for minerals and metals were prompted by the strong criticism of the percentage depletion rate for petroleum. Yet in reducing that particular rate, the House reduced the rate for almost all minerals heretofore granted percentage depletion by the Congress.

Sand and gravel is not an inexhaustible natural resource. Our industry, says the U.S. Bureau of Mines, is the largest non-fuel mineral industry in the United States. In 1968, according to a report of the Bureau, our industry produced 918 million tons of sand and gravel, the value of which exceeded one billion dollars. The Bureau added that the demand for sand and gravel "is greater than the combined demand for the rest of the non-fuel nonmetallic minerals."

Our industry plays a vital role in the Nation's economy, in war and peace. Our industry is proud to be able to say that it has bought and leased land at high cost and has bought and installed equipment at equally high cost without governmental subsidy or financing in any form. Ours is a privately owned and managed small-business industry, making available to the United States in every area of our country a valuable and essential natural resource, without which this country could not fight a war, prepare for the possibility of another war, maintain this country's high standard of living, and make it possible for our country to undertake a program for urban development and housing on a large scale to accommodate the predicted increase of 100 million people in the metropolitan areas by 1992.

Let me go a bit farther in my effort to make it clear to this Committee that ours is indeed an essential industry. Our country could not have airports: our country could not have defense plants, without using sand or gravel or both as the first step in building these structures. We could not have public utilities such as electricity, water, telephone, gas and sanitary facilities; our country could not have homes, schools, colleges, churches, commercial structures, shopping centers, parking lots—all of the essential elements of community living in the United States, unless sand and gravel of a suitable quality is available at an economical price.

I emphasize the latter because there is seemingly a popular assumption in this country that, while other natural resources may be limited in both availability and quality, this is not true of sand and gravel. The very opposite is the fact: In the last statistical study of sand and gravel reserves conducted by the Association in 1963, it was estimated then that, on a national average, currently held reserves had a life expectancy of 24 years. It should be pointed out, however, that this estimate was based on an annual rate of production which has substantially increased since 1963 and which all forecasts predict will further increase dramatically. Additionally, average life expectancy of reserve deposits is substantially less in major metropolitan areas where the demand for sand and gravel is the highest.

One day our country will surely discover that the largest member of the mining family is being driven farther and farther away from the sites at which sand and gravel is used and that therefore the cost of construction of all types will be substantially increased, because transportation costs are the dominating factor in sand and gravel prices. The farther we are removed from the markets we serve, the higher the cost and the greater the price which the country will have to pay to carry on a great construction program.

Let me give you a brief review of how the demand for sand and gravel of suitable quality at a reasonable price has grown in just recent years. Our production in 1955 totaled 592 million tons. In 1956, production increased to 625 million tons; in 1959, production totaled 730 million tons. You will quickly see that as compared with 1955, our production in 1968 had increased by more than 50 percent to 918 million tons, a staggering increase which I believe will impress this Committee.

Even so, however, the American Society of Planning Officials stated that in the 30-year period from 1962 to 1992, construction facilities for the projected increase of 100 millon people in metropolitan areas would make it necessary for the sand and gravel industry to produce 45 billion tons of sand and gravel in these 30 years. Even if our current rate of production were not increased at all in the 30-year period, our industry would still have to produce 27 billion tons of sand and gravel!

The U.S. Bureau of Mines, in a study entitled "Cumulative Demand Projections for Sand and Gravel", estimates that in the period between 1970 and the year 2,000, construction demands would make it necessary for the sand and gravel industry to produce "in the range from 57.2 to 65.6 billion tons." It is clear from these impressive data developed by two reputable organizations, one private and the other public, that our industry must produce close to 66 billion tons of sand and gravel in the next 30 years.

To produce anywhere near that much sand and gravel, our industry must be able to locate and develop land with sand and gravel deposits of suitable quality, locations which are close to metropolitan areas in order to avoid excessive transportation costs. This brings up still another problem: where in the world is our industry going to find the deposits to produce so much sand and gravel in 30 years, and how is it going to be financially able to acquire such land unless the Congress of the United States permits our industry to continue to use its present percentage depletion allowance of five percent?

Due to prevailing misconceptions about the vital role which the sand and gravel industry plays, and due also to expanding metropolitan areas which cover up valuable sand and gravel reserves which will thus be forever unavailable to us for sand and gravel development, our industry has to contend with unduly restrictive zoning controls. Some land planners, uninformed about the growing scarcity of good quality material near enough to the point of use to be economically feasible, have imposed unbearable zoning requirements on the sand and gravel industry.

Yet in other areas, there is a gratifying awareness by land planners that the country must have sand and gravel if it is not to stand still. In some jurisdictions, znoing regulations set aside specific areas for sand and gravel production, the codes stipulating that sand and gravel is an importan natural resource and that it must be made available to the people living in their jurisdictions.

Privately financed non-public construction dominates our country's great construction program. Our country is continuing to move forward with a construction program which, while taking due account of defense and public works, still motivated principally by investors who use their own money to show their faith in our country's future. Reflected here is the characteristic determination of the United States never to stand still in its advance toward a better way of life. To prepare our defenses and to build the things which are essential to our way of life, this country must be able to obtain sand and gravel of good quality at a reasonable cost.

The National Sand and Gravel Association understands and accepts the necessity for intelligent zoning standards. We recognize that there is a growing overall land shortage in our industry. We have cooperated with the Department of the Interior and with the American Society of Planning Officials in the development of performance standards which will reserve to the communities the availability of sand and gravel of good quality and which will demonstrate to the public that we recognize the legitimate public interest in the way we operate. We have done everything within our power to be a good neighbor.

We believe that this image of our industry as a good neighbor is already recognized in responsible circles. In a speech at our 50th Annual Convention in 1966, John A. Carver, Jr., then Under Secretary of the Department of the Interior, said that "your industry was already in the vanguard of a belated national effort" to conserve our country's natural resources. He added this observation of our work: "Let me say, here and now, that the work you have done in encouraging your members to follow the excellent example of those who have been most successful in site rehabilitation is entitled to the highest commendation and and I take great pleasure in extending that recognition—unstintingly." This was a compliment which we shall always treasure.

Land costs have risen at a skyrocketing rate, as you know, in the past 15 years. There is no indication that these costs will decline, thus aggravating a problem which is perhaps more destructive in the case of the sand and gravel industry than in any other natural resource industry. Since sand and gravel operations must be located close to the metropolitan areas which provide our principal markets, members of our industry must pay many times the price for land paid by other natural resource industries.

Our industry must warn the country that without a percentage depletion allowance of at least 5 percent, we will not be able to locate and acquire the land which is necessary to produce the sand and gravel which the country must have in order to sustain its building and construction program—public or private. The 5 percent depletion allowance for sand and gravel has been indispensable to our industry in meeting the heavy capital charges involved in obtaining sand and gravel deposits of suitable quality.

The first step toward sand and gravel production is exploration for new sources of supply, and then a determination of the characteristics and quantities of material. The sand and gravel must be examined as to mineral composition, quantity and nature of impurities, soundness, strength and size of grading. In order to meet the wide range of increasingly strict specifications, the question of whether the material can be economically produced to meet requirements is one that can be answered only by sound engineering judgment, based on experience coupled with careful survey of the deposit and the market for its products.

No other mining industry is so widely dispersed as our industry. Our operations are found in every state of the Union and in most of the counties and cities. I have described our 5 percent allowance as very modest. It is! I sincerely believe that if the Congress were to make an independent analysis of the percentage depletion rate for sand and gravel, it too would agree that the 5 percent allowance is indeed modest and that its continuation is necessary in order to turn out the billions of tons of sand and gravel which we will be called upon to produce in the years ahead.

Our industry has built its own plants and bought or leased its own land. We have not sought or obtained governmental help in financing our industry's operations or in any other device for protecting our industry in one way or another. Ours is a characteristically free enterprise business. We intend to keep it that way. Taxation problems, however, are very real ones and costs of operation mount every year. Essential to our ability to survive is a percentage depletion allowance which reflects the realities in the case of an industry which has never failed the United States, in war or in peace. We ask that the 5 percent depletion rate for sand and gravel be continued.

Statement of Earle T. Andrews for the National Industrial Sand Association

I am Earle T. Andrews, a member of the Taxation Committee of the National Industrial Sand Association of Silver Spring, Maryland, and am submitting this statement on behalf of all members of the Association. I am also Chairman of the Board, Pennsylvania Glass Sand Corporation, Hancock, West Virginia. We appreciate this opportunity of presenting our views to the Committee on the provisions of Section 501(a) of H.R. 13270.

The National Industrial Sand Association is an industry association representing approximately 85 percent of the production of industrial sands in the United States. Industrial sand is a general term for quarzite and also quartz sand and pebbles used or sold for purposes dependent upon their silica content or their chemical or refractory properties. Industrial sand is a primary raw material used in the manufacture of glass, chemicals, electrical porcelains and other silica based products and as metallurgical sand required in the manufacture of ferrous and nonferrous metal products. These constitute the primary markets although there are over 100 industrial and technical commercial uses requiring the unique chemical and physical properties of industrial sand.

Construction sand used as a concrete aggregate and for other general building purposes and industrial sand are dissimilar in origin, in methods or processing and are mutually exclusive in use.

Industrial sand is presently authorized percentage depletion at 15 percent;[1] under the House bill, the allowable rate would be cut to 11 percent. The Ways and Means Committee reported that it believes (1) "that even if percentage depletion rates are viewed as a needed stimulant at the present time they are higher than is needed to achieve the desired beneficial effect on reserves; and (2) "that there is need to strike a better balance than now exists between the objective of encouraging the discovery of new reserves and the level and revenue cost of percentage depletion allowances."

The National Industrial Sand Association opposes the proposed reduction in the existing 15 percent depletion rate. The conclusions of the Ways and Means Committee were not based upon any study of either the industrial sand industry or the mining industries generally. Indeed, it is doubtful that the Committee even considered the impact of the proposed rate reductions on any minerals other than oil and gas.

The United States has long had a National policy carefully designed to assure an adequate supply of mineral raw materials to meet the requirements of an expanding economy and the needs of security, and to bring about an orderly and wise use of this country's natural mineral resources. Mineral resources are wasting assets, and percentage depletion recognizes this fundamental reality—presently available mineral deposits are gradually being exhausted by the extractive industries and additional reserves must be found and obtained.

Percentage depletion and the National minerals policy generally have fostered the development of this country's natural mineral resources which in turn is tied directly to the United States' amazing economic growth. Dr. Walter R. Hibbard Jr., Director of the Bureau of Mines, stated, at hearings on mineral shortages before the Subcommittee on Minerals, Materials and Fuels of the Senate Interior Committee on March 21, 1968, that:

"Our mineral production is 2.9% of the U.S. GNP but it has a direct impact on 40% of the U.S. GNP and an indirect impact on nearly 75% of the U.S. GNP. It makes a dollar turn around several times. It makes resources grist for the economic mill." See Page 32.

Tax reform, whether it be intended to eliminate inequities, to redistribute the burdens of taxation, or to simplify the assessment of liability, should not be allowed to reverse unintentionally the National minerals policy. If the proposed rate reductions are intended to change this policy, as the report of the Ways and Means Committee indicates, the full impact of these changes, not merely the symbolism of reform and the revenue gain, should be thoroughly considered.

Industrial sand is a small industry. As reported by the Department of Interior, total production of industrial sand in 1967 amounted to 25,323,000 short tons and was valued at $85,855,000. The amount of the aggregate percentage depletion deduction for industrial sand is not available, but the total value of the industry's production establishes that the proposed rate reduction cannot increase National revenues substantially. Individual producers of industrial sand, however, will be confronted by a sharp cutback of almost 27 percent in their allowable depletion deduction.

Percentage depletion has become an integral part of the economics of the industrial sand industry. The proposed rate reduction would be a serious dislocation. Prices would need to be raised substantially to offset the lower depletion deductions. The impact of the rate reduction is not likely to be overcome satisfactorily by price increases, and the likely consequences include curtailed exploration and development of new deposits; less research into mineral recovery methods, especially for lower grade deposits; and lower modernization of operating methods. These consequences would be significant in the case of industrial sand. Industrial sand uses require a high purity silica and the present state of technology offers no means of beneficiating a quartz grain in which extrinsic elements in so-called solid solution exceed permissible limits. This is the controlling criterion in the final selection of industrial sand deposits, and the geologic characteristics presently required are restricted to very limited areas.

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[1] There is no rate specified for industrial sand as such. Quartzite, however, is specifically entitled to depletion at the 15 percent rate. The legislative history of the 1954 Code also states clearly that the 15 percent rate is intended for quartz sand and quartz pebbles when used or sold for purposes dependent upon their silica content or their chemical or refractory properties.

Adequate supplies of industrial sand are not easily located, developed or processed into marketable levels of purity. Extensive exploration and development and sophisticated and expensive processing are required to meet today's demands much less the increasing needs of the future.

The conclusion that must be drawn is that the economic disclosure of the proposed percentage depletion rate reduction will affect the capital values—the risk element—of industrial sand producers with adverse effects on supply of this important mineral.

The other provisions of the House bill applicable to all businesses serve whatever may be the reasonable demands of tax reform on the mining industry.

The CHAIRMAN. The next witness is Mr. S. James Campbell, National Crushed Stone Association, accompanied by Mr. Robert M. Scott, counsel.

STATEMENT OF S. JAMES CAMPBELL, EXECUTIVE VICE PRESIDENT OF HARRY T. CAMPBELL SONS CO., TOWSON, MD.; ACCOMPANIED BY ROBERT M. SCOTT, COUNSEL

Mr. CAMPBELL. Thank you, Mr. Chairman.

Senator, members of the Finance Committee. I am S. James Campbell—

The CHAIRMAN. Excuse me. We have a letter here of introduction sent by Senator Tydings and Senator Mathias. I would like to ask that that be included in the record at this point.

(The letter referred to follows:)

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C., September 25, 1969.

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

DEAR MR. CHAIRMAN: This letter must serve as an introduction for Mr. S. James Campbell of Towson, Maryland, as the press of our own Committee business makes it impossible for us to attend your Committee's hearing on September 30.

Mr. Campbell is appearing on behalf of the National Crushed Stone Association. He is executive vice-president of Harry T. Campbell Sons Company, of Towson. Established in 1892, his firm is a major producer of aggregate and related products in the Baltimore area. It also conducts business in Massachusetts, New York, New Jersey, and Pennsylvania. Mr. Campbell has been active in the business since 1946.

The National Crushed Stone Association represents some 500 members, ranging from large corporate enterprises with dozens of quarries to one-quarry family operations. About 65 percent of annual domestic production of crushed stone comes from Association members.

The role of the crushed stone industry in fulfilling the nation's construction needs hardly requires emphasis. We are certain that the Committee will extend every consideration to Mr. Campbell's testimony in its deliberations.

With best wishes.

Sincerely,

JOSEPH D. TYDINGS,
CHARLES McC. MATHIAS, Jr.,
U.S. Senators.

MR. CAMPBELL. I am S. James Campbell, Executive Vice President of the Harry T. Campbell Sons' Company in Towson, Maryland. I am accompanied by Mr. Robert M. Scott, counsel to our National Crushed Stone Association.

I am here today testifying on behalf of the National Crushed Stone Association and all stone producers to let you know why we feel that the present depletion rates granted our industry now should definitely be maintained. The reasons that the depletion was granted by Congress to our industry in 1951, that is to encourage the search for and the production of quality stone, were valid then and are much more valid today.

We believe that tax reform should be based upon true correction of inequities and thereby a need to eliminate or modify the applicable tax provisions. If the reasons for depletion for crushed stone were sound when they were passed, there is no need to consider reduction in depletion as a tax reform today. If the original reasons for such provision require its continuance, then a change in a tax provision is not a reform.

We would like to summarize briefly our statement, which covers the problems of the crushed stone industry, and why we feel the existing rates are all the more necessary. Briefly you have heard from other sources about the vital products that the crushed stone industry produces. They are basic to the economy. The industry does not have the glamor of copper, gold, silver, oil shale, iron ore, but you gentlemen are well aware of the amount of stone that is essential to nearly every facet of our everyday living—just take transportation alone, the stone that goes in the road beds of our railroads, in our highways and airfields. In addition, the building of dams, agricultural limestone, fluxing stone for steel, requires specialized stone products. All of these uses are basic and we need to develop the sources of supply further.

I think you would agree with this. These uses are critical to the economy of the country.

There is a growing demand for our products. When depletion was passed in 1951, our industry was producing 364 million tons of stone, and just 17 years since then, with the assistance of the depletion allowance, we have been able to more than double that rate of production to some 815 million tons.

The Bureau of Mines notes that by 1985 production must be increased between 50 and 75 percent.

To accomplish these goals for this basic material which is important for the rebuilding and the building of our future cities and highways, the depletion allowance must be retained if not increased.

To understand this, and why we are so sincere about our position, the economics of our crushed stone industry will be important to you. It is certainly not an industry to be undertaken by the fainthearted. You cannot just buy land and start digging.

As you may have noted, our industry requires heavy capital investment. A typical crushed stone plant constructed today requires somewhere between a $1 and $2 million investment to open a quarry site and place it in production.

We have detailed in our statement how we have arrived at these costs. Just one example: The primary crusher in a quarry can weigh up to 150 tons, and can cost anywhere from $100,000 to $200,000 for that one single installation.

There are lots of risks that have to be decided upon when you venture into this industry. The first one is to realize that just any stone is not marketable stone. The specifications for our products these days are continually being tightened. Densities, hardness, soundness, gradation, particle shape all control whether or not your stone is marketable.

It is extremely difficult to find this marketable material and it is becoming more costly. As technology has advanced and specifications have been tightened, it is obvious that many sources for stone that were previously considered good reserves are no longer good reserves.

I believe we want to highlight one aspect of our problems that perhaps is more important to our industry than other mining industries, and that is the zoning restrictions we face today. For our particular products, the prime markets are in the urban areas, and in federally sponsored and financed building projects in these metropolitan areas. With increased population growth in urban areas and attention to environmental aspects of our national life, zoning restrictions probably represent the greatest risk problem we face since it is not possible to adequately plan for changing requirements brought about by changes in urban living patterns and aesthetic considerations. This risk is not only getting your property properly zoned initially after it has been found through professional techniques, but being able to maintain appropriate zoning after it becomes a going operation. We have cases where going operations have been zoned out of business. We have cases where reserve land has been taken away from use by our industry, which has completely invalidated the investment values.

The continuing risk factors for our industry perhaps should be emphasized. Long after you have invested your money in exploration for your plant, such risks as development of sinkholes around your quarry property, water intrusions causing flooding and faults can occur, all of which can reduce the quantity of stone which again completely distorts the return on your investment.

Stone is peculiar in that many times while the tests in the lab would indicate it would meet certain specifications, it is impossible to fully predict whether the material will meet the job specifications when it is used. Often after complete investments have been made, your customers inform you unfortunately that the specifications for a particular use are not being met and your investment again can be lost or seriously affected.

Purchasing parties have been changing specifications on our products. There are many examples of these risks. I have with me information on recent cases where the question of whether certain stones are slippery in road surfaces has completely distorted investment in our industry. Certain plants that have produced good materials have suddenly been told their stone no longer meets certain qualifications. We feel there is much work to be done in determining whether these skid resistance specifications are correct or not, but nevertheless they are in effect. They are a fact of life.

The real risk we have is that the ever-expanding national population has brought zoning problems to us along with other regulations that our industry is now facing, such as air and water pollution which have increased as urban areas have developed around our operations.

There are extremely heavy investments required to meet these regulations which our industry is making, in addition to the already heavy investment capital. This is an added problem and presents an added risk if the deposit will continue to meet specifications.

Many areas are requiring our industry to go to underground mining rather than open pits because of their nearness to urban areas. Again the risks in underground mining, as have been noted by others, are greater than open pit. Underground waters and ceiling failures are examples of these risks, just to mention a couple.

Our former rural area locations that now find themselves surrounded by homes are bringing us constant problems. There is many a citizen group, as perhaps you gentlemen are aware, that would like to close down these quarries. This is a real risk. With these risks with which we are faced, we need the current depletion rates to provide the incentive to keep our industry moving forward, to provide the kind of tonnage that we must have if we are going to rebuild this Nation.

We do not believe the House Ways and Means Committee or this committee has heard any testimony to the fact that our risks have not greatly multiplied. Therefore, the depletion rates which were sound when granted are even more sound now.

Percentage depletion for the stone industry is not a loophole. It is not a special provision favoring a few. It is the incentive that Congress has provided to induce a person to invest his money. The problems we have, the risks we have, are easily illustrated by many known situations. Such as:

A single hole operation was successfully sued as a nuisance and the operation completely closed. A 20-foot seam in an operating quarry was found not to meet the current specifications, resulting in the whole quarry operation becoming completely uneconomical. The cost of land reserves of stone has increased the past few years from several hundred dollars an acre to several thousand dollars an acre. A recent purchase of reserve lands cost approximately $5,000 an acre.

Land purchases in a certain State that were thought by professional geologists to contain stone ended up with a limited deposit on top and a steeply sloping bed underneath which was impossible to mine economically. Again the whole investment in that plant, despite the best technology available, was wasted.

Today many specifications call for washed crushed stone for the concrete industry which is a major customer for crushed stone producers. Therefore, we cannot open a stone deposit unless we have a water reserve or water source near that stone deposit.

One final thought. As you have noted, the mining industry needs one of the heaviest capital investment among industry groups. If the investment tax credit is withdrawn, as would seem likely, we suggest that this action is going to have a compounding effect on mining activities. As a result, the mining industry is going to suffer greater tax consequences than will any other industry.

We urge this committee to retain the present rates of depletion for the crushed stone industry, in order that the needs of this Nation will be properly supplied in 1985 to the year 2000.

Gentlemen, the future is in your hands. Thank you.

The CHAIRMAN. Thank you very much.

Senator MILLER. What is the total annual sales of "Agricultural stone" of your industry and what is "agricultural stone"?

Mr. CAMPBELL. Senator, as to the definition of "agricultural stone", I believe the following to be a reasonable one:

> Stone whose chemical content is capable of (1) neutralizing soil acidity, (2) supplementing a soil which is chemically deficient for its normal purposes, or (3) supplementing the dietary needs of poultry or other farm animals.

Agricultural stone basically consists of limestone and dolomite; however, calcareous marl, granite, marble and shell are included in the definition, albeit the quantities are quite small in comparison.

In the year 1968, according to the most recent figures we have been provided by the U. S. Bureau of Mines, the following quantities of these various kinds of stone—and the f.o.b. prices thereof—were either shipped or sold by the industry for agricultural purposes:

	Tons	Amount
Calcerous marl	186,000	−$150,000
Granite	105,000	−994,000
Shell	263,000	−2,378,000
Marble	424,000	−1,313,000
Limestone and dolomite	38,369,000	−68,988,000
Total	39,320,000	73,823,000

Senator MILLER. What is estimated annual depletion allowance—at 15 percent rate—for your industry for agricultural stone?

Mr. CAMPBELL. I can only give you an estimate, as you recognize. If the gross f.o.b. sales price I have stated in answer to your preceding question is multiplied by 15 percent, the answer is $11,073,450. But that figure would be high by virtue of (1) the requirement that sales income be reduced by items such as rents and royalties before the 15 percent is applied; (2) the fact that the f.o.b. sales price figure given above may not accurately reflect the figure against which the Internal Revenue Service permits a producer to take depletion because of the "cutoff" provisions in the tax regulations; and (3) the fact that the amount of depletion a producer can take is limited to 50 percent of its net income. Since there is no information available to the public or to this association that would give the actual amount of depletion taken by each company in its income tax returns, I cannot say whether, or by how much, that $11,073,450 figure would be decreased.

Senator MILLER. Please relate the foregoing to any estimates you wish to submit regarding increased costs to the agriculture industry if there is a reduction in the 15 percent rate to that provided in the House-passed "tax reform" bill.

Mr. CAMPBELL. Applying the same caveats I did in the preceding answer, I estimate that a reduction from 15 to 11 percent would cost the industry an additional $1,500,000 in taxes. Some portion of this increased cost of doing business (higher taxes) would very likely be passed on to the farmer, but I could not predict how much. If a substantial part could not be, the ultimate result of such reduced incentive to the agricultural stone producer could well be his failure to locate and open the quarries needed to supply the farmer. The farmer too late would realize that he no longer had sufficient availability of these important soil nutriments within an economical distance of his farm, and would be faced with the choice of lower productivity of his land or much higher costs of replacement fertilizers for his soil.

Mr. CAMPBELL. Thank you.

(Mr. Campbell's prepared statement follows:)

Statement of S. James Campbell, on Behalf of National Crushed Stone Association

SUMMARY

The reason which caused the Congress in 1951 to grant the crushed stone industry a depletion allowance of 5% on construction aggregates and 15% on chemical and agricultural stone today even more compellingly require the continuance thereof.

Without any question, stone is vital to the growth of this nation. Its use is required to maintain our network of transportation facilities: For highways, for train roadbeds, for airstrips. Stone is needed for dams, for building of all kinds. Stone (agricultural limestone) is essential for a bountiful agricultural production. It is necessary for the production of steel and many other products.

The demand for stone is ever increasing. The U.S. Bureau of Mines projects that stone production will have to increase by 50-75% by 1985 and by approximately 150% by 2000, if the needs therefor are to be fulfilled.

Incentive in the form of the depletion allowance is needed if the production of stone is to meet those projections, for marketable stone is becoming more difficult to locate, the capital investment required to open and develop a stone quarry is becoming greater and so are the risks attendant upon the stone producing business.

The cost of the machines and equipment one must have to open and operate a quarry can easily run between one and two million dollars, and this does not count the cost of the land. Yet a stone producer is never certain after he has located a deposit and made the necessary investment that such investment will not be lost by reason of risks other than those normal to any business. Both the quality and the quantity of the stone may fail in their expectations due to the uncertainties that accompany any mining operation.

But the stone producer is also subjected to other risks of an entirely different, but equally unpredictable, nature: He may find himself "zoned out" of business entirely by new zoning laws, or he may be "forced out" financially because of the cost of complying with newly passed air, water and noise regulations.

The foregoing reasons require the continuance of the present depletion rates. We believe that a change in a tax provision is not a "reform", if the reasons which prompted the provision originally remain valid. We submit that we have shown they do remain valid. No one has suggested, insofar as this industry is concerned, that they do not.

The depletion allowance is not a "loop hole". It is not a special provision favoring a few. It is the incentive the Congress has provided to induce any person to invest his money in the stone producing business in order that the requirements of this nation for stone products will be fulfilled.

We urge this Committee to retain the present rates of depletion for the crushed stone industry in order that the needs of this nation will be properly supplied in 1985 and in 2000.

STATEMENT

My name is S. James Campbell. I am Executive Vice President of Harry T. Campbell Sons' Company, Towson, Maryland.

This statement, filed by the National Crushed Stone Association of which I am the spokesman today, is submitted on the behalf of its members and all other stone producers for the purpose of informing the members of this Committee and the members of the Senate generally of the reasons the depletion rates now allowed upon the mining and production of crushed stone for construction, chemical, flux and agricultural limestone uses should not be reduced.

By the Revenue Act of 1951, Congress determined that companies engaged in the mining and production of crushed stone required a depletion allowance in order to encourage the search for and the production of, products that were vital to the economy and well-being of this country.[1] That decision was sound then and the reasons which made it sound at that time today serve not only to ratify its soundness but to compel the continuance of the present depletion rates.

We believe that tax "reform" should be based upon a need to eliminate or

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[1] The rate of 5 percent is allowed on construction aggregates and 15 percent on chemical and agricultural stone. Under the provisions of H.R. 13270, the rates would become, respectively, 4 percent and 11 percent (Sec. 501(b)(7) and (8)).

modify those tax provisions which, although sound when passed, no longer serve the purpose they were intended because the reasons therefor no longer exist. But a change in a tax provisions is not "reform" if the original reasons for such provision require its continuance.

To appreciate that those reasons which made the original granting of the depletion allowance to the crushed stone industry a sound decision today require that the existing rates be continued—if not increased—, the facts surrounding the crushed stone industry, including the risks attendant thereto, and the demand for its products must be examined.

1. The Products of the Crushed Stone Industry are Vital to the Growth and Security of the Nation.

Stone may not have the glamor that copper, gold, silver, oil shale and iron ore have, but its production is just as essential to the growth and security of this country as the production of any of those minerals.

Take transportation—stone must be produced to provide roads on which cars and trucks can move, roadbeds on which trains can travel and airfields so planes may operate. Take construction—stone must be produced for buildings and dams to be erected. Take agriculture—without agricultural limestone farm production would not flourish. Take steel—without fluxing stone steel could not be produced. All of the foregoing industries are basic ones and stone is required for each. But it is also a necessary ingredient for the products of many other industries—paint, glass, pharmaceutical to name a few. We need not labor the point that stone is an essential and critical product to the economy of this nation, for the myriad uses to which stone in its many forms is put can leave no doubt that its its production has been, is and will continue to be an absolute necessity to the growth and security of this nation.

2. The Future Demand for the Products of This Industry.

In 1951, the year Congress granted the crushed stone industry a depletion allowance and established the present rates, 364,484,000 tons of stone were produced and used in the United States. By 1968,—just 17 years thereafter—the members of this industry were, with the assistance of the depletion allowance, able to more than double that rate of production and thereby to keep pace with the great demands for its products. But the 815,946,000 tons produced in 1968 must be increased, according to the latest projections of the U.S. Bureau of Mines, between 50% and 75% by 1985 to stay abreast of the requirements of this nation and it must be more than doubled by the year 2000 if the stone producing industry is to fulfill its obligations to serve the needs of the burgeoning population.

To accomplish the goals forecast by the U.S. Bureau of Mines, the existing depletion rates allowed the stone producing industry must be retained—if not increased—, as we shall show below.

3. The Economics of the Crushed Stone Industry.

To appreciate that any lowering of the present depletion rates granted the crushed stone industry will adversely affect the production of stone, the facts relative to the production of stone must be understood.

The crushed stone business is not one to be undertaken by the faint-hearted. Today, it is a business that entails heavy capital investment and many risks. I am afraid that too many people have the mistaken idea that all one has to do to produce stone is to buy some land and to start digging. Such is not the fact.

The production of stone requires heavy capital investment. Conservatively speaking, it will cost between one million dollars and two million dollars to open a quarry and place it in operation. First one must strip the overburden which requires heavy loading equipment (shovels, bulldozers, pans and trucks), the cost of which can be $50,000–$90,000. After stripping, one must have one or more heavy shovels ($80,000–$210,000 a piece), quarry trucks ($45,000–$75,000 each), a primary crusher—which can weigh up to 150 tons ($100,000–$250,000), heavy duty conveyors ($45,000–$300,000), secondary and tertiary crushers ($50,000–$100,000), screening and washing equipment ($150,000–$250,000), dust collectors ($70,000–$230,000), and various miscellaneous items (such as dryers, bins, loading equipment, delivery trucks and trailers, and weighing stations). Thus, it may be seen that one cannot open a stone quarry without making it a very heavy investment in machines and equipment. And this does not include the cost of the land, including land needed as buffer area, nor the exploration costs incurred to locate the deposit.

What risks face the man who must decide whether to put that kind of money into a stone producing operation beyond those that are faced ordinarily by any business venture? There are many.

One must disabuse himself of the thought that stone is stone and that any stone is marketable stone. To comply with the specifications of the several states and the Federal Government that deal with highway construction, for example, one must produce stone of particular densities, hardness, soundness, gradation, particle shape and other requirements depending on the area. If one is to service agricultural needs, one must have limestone that is of high calcium and/or high magnesium content. Special qualities must exist in stone that is used for flux. In short, a good portion of the stone that is in the ground is not of marketable quality.

Moreover, that which is of marketable quality is becoming more difficult and more costly to find. This is due not only to the past and the present great demand for stone products, but it is also the result of the advancement in the knowledge of the characteristics of stone and, as a consequence, the creation of more specialized specifications by purchasers of stone. And it is due also to the fact that a number of otherwise available marketable reserves cannot be utilized today because of zoning restrictions which preclude quarrying operations in certain areas. The hunt for available reserves of stone that will meet particular market requirements encompasses more than a stroll across the country side. Utilization of geographical and geological information and exploration techniques by professional geologists are prerequisites in the search for stone of particular characteristics, all of which entails large expense. An area which preliminarily appears feasible is first subjected to one or more of a number of general survey techniques (aerial photography, surficial mapping etc.) and then to core drilling. A scientific analysis of the core samples is made to determine the characterstics of the stone. Should the desired characteristics be found, the area is then re-mapped on the basis of such cores to determine if a commercially feasible quantity is available. Should the available information thus obtained so indicate, the great investment necessary to open a quarry is made. Nevertheless, certain very real risks remain.

Let us present them to you for your consideration. Besides those risks that are inherent in the production of any mineral that lies beneath the surface of the land—in the case of stone production unexpected "sink-holes," water intrusions and faults which reduce the quantity of stone that was anticipated and upon which the determination to invest was made—, other risks are faced by a stone producer. One of these is attributable to the empirical nature of stone, that is, stone does not always perform in actual use as the tests thereof indicate it will. Although the core samples and the stone when produced at the quarry may have passed the applicable specifications, such stone still may prove unsatisfactory in actual use. When this phenomenon occurs, that stone is excluded by the purchasing party for future use, despite its theoretical acceptability, and the stone producer's investment in that quarry is lost.

Another risk the stone producer runs is that, having made an investment in a quarry because the stone met certain specifications, the purchasing parties may change their specifications in such a manner as to eliminate that stone from consideration. When this is done, the stone producer's investment in that quarry may be rendered valueless because—unlike a manufacturer of a product—there is often nothing he can do to change the characteristics of his product to meet the newly specified quality requirements.

But there are other most significant kinds of risks we face today—risks that, because of the ever expanding population, are ever more present—those arising from zoning and related legislation. Time and again land that had been purchased by a stone producer for future development as a quarry has been "zoned out" for that purpose with the result that the added investment made in the land for such purpose is a total loss. Of even greater threat to the stone producer is the chance that his land which is currently being worked as a quarry and the investment in the machines and equipment used in such operation will be rendered of substantially less—or of no—value by zoning and related restrictions which require that he stop using the land as a quarry. *Goldblatt v. Town of Hempstead*, 369 U.S. 590 (1962).

Not only do we face the risk of being "zoned out" of business by zoning and related laws without any recourse, but some of those laws now require that mining for stone be undertaken only when it is done underground. Such requirement not only increases greatly the actual cost of producing stone, but the possibility of underground water problems and of ceiling failures due to unsuitable stone structures add greatly to the risks of producing needed stone.

As adjuncts to the zoning problems which confront us, there are those that arise by reason of air and water pollution legislation. The additional costs that can be—and are—imposed by such legislation can make a currently profitable operation a losing one.

The possibility of being either "zoned out" of business or of being forced out by the extra costs attributable to air and water pollution legislation is becoming greater each year. This is due to the simple fact that our population is growing at such a great rate that our once rural areas are now residential areas whose residents would prefer that a stone producer close his existing operations and move elsewhere. Although we seek constantly to effect anti-pollution and anti-noise measures that will make stone producing operations more acceptable to our neighbors, there is more and more pressure being mounted by citizens' groups to close quarries that now find themselves surrounded by homes. It is an ever present risk that confronts those of us in the stone producing business and adds to our reluctance to open new quarries.

We ask your favorable consideration of our plea that the present rates of depletion granted the stone producers not be reduced. For one to venture the very heavy capital investment required to find and to open a stone quarry in the face of the extraordinary uncertainties that face this industry—the many possibilities to lose a great portion or all of one's investment by reason of factors that cannot be controlled by the investor—requires that he have the necessary incentive. The present depletion rates have served this purpose in the past: The stone that was needed to fulfill the demands of the nation in the Fifties and Sixties was supplied because Congress had provided that incentive necessary to persuade people to take the risk of investing their money in this business. The future demand for the products of this industry are such that additional supply must be found if that demand is to be met. Yet despite the fact that the risks of the business have increased as have its costs—*and neither this Committee nor the Ways and Means Committee has heard any testimony to the contrary*—a reduction in those rates which provided the incentive to produce the needed stone in the pas thas been proposed in H. R. 13270. Such action, in our judgment, will cause the capital required to find and open the new quarries that will be required to meet that demand to move to other fields where fewer risks are involved. As I said earlier, a change in a tax provision is not a "reform" if the reasons which prompted the provision originally remain valid. We submit that we have shown that they do remain valid. No one has suggested they do not.

The depletion allowance is not a "loop hole." It is not a special provision favoring a few. It is the incentive the Congress has provided to induce any person to invest his money in the stone producing business in order that the requirements of this nation for stone products will be fulfilled.

I would add one more consideration: Because of the heavier capital investment required to purchase the great machines and equipment needed in the mining industry generally, the investment tax credit has been particularly helpful in keeping our operations abreast of the many innovations recently made in mining machines and equipment. If that tax credit is withdrawn, as seems likely, and there is a reduction of the depletion allowance, this industry will suffer greater tax consequences than will other industries.

We urge this Committee to retain the present rates of depletion for the crushed stone industry in order that the needs of this nation will be properly supplied in 1985 and 2000.

The CHAIRMAN. The next witness will be Mr. Philip L. Corson and Mr. Robert S. Boynton, National Lime Association Tax Committee.

STATEMENT OF PHILIP L. CORSON AND ROBERT S. BOYNTON, NATIONAL LIME ASSOCIATION TAX COMMITTEE

Mr. CORSON. Good morning.

The CHAIRMAN. Pleased to have you here, sir.

Mr. CORSON. Thank you, Mr. Chairman.

My name is Philip L. Corson. I am chairman of the board of G. & W. H. Corson, Inc., a quarrier and processor of limestone and manufacturer of lime in southeastern Pennsylvania. I am appearing today as the chairman of the Tax Committee of the National Limestone. This association represents over 85 percent of the commercial lime capacity in the United States. The products of its members are quicklime, hydrated lime, crushed stone for the metallurgical chemical processing industries and for other purposes.

We wish to protest the proposed cutback in the depletion rates on limestone embodied in the tax reform bill H.R. 13270. We would greatly appreciate your consideration of the following arguments in support of our position.

Essentially for metallurgical and chemical users of limestone and for lime manufacturers, the highest quality of limestone is required to satisfy stringent specifications on purity. Such stone must meet a minimum of 95 percent of total carbonate content as well as meet specific tolerances on impurities.

Limestone is one of the key basic building blocks that is vital to industry. Directly or indirectly as stone or limestone it enters into the manufacture of most products. In most instances its uses are irreplaceable. There is no substitute.

Nearly one-third of a ton of limestone is required to produce a ton of steel. Thus it is difficult for us to reconcile how iron ore escaped the proposed cut where limestone did not. Both of these vital basic materials should be accorded equal treatment.

In like fashion, limestone or lime is essential in copper ore beneficiation and copper refining. If copper retains its 15 percent depletion rates, we believe that limestone should too.

It is an essential raw material for alumina and magnesia from which metallic aluminium and magnesium are made by reduction. Similarly it is essential in the manufacture of many chemicals, glass, sulphate paper, animal feed, sugar, and for potable water purification and sewage and trade waste treatment.

There are numerous other uses for limestone and lime, so many that chemical and metallurgical grade limestone has long been recognized as strategically necessary for national defense. Moreover, in the growing movement to arrest air pollution, limestone and hydrated lime offers possibly the most economical method of neutralizing noxious sulfur fuels from industrial stacks.

Thus without limestone, modern industry would cease.

2. The relative scarcity. Currently, about 72 million tons of metallurgical and chemical grade limestone is being consumed annually. Such a massive withdrawal of our natural resources depletes existing deposits. To replace exhausted deposits, costly geologic exploration and development is essential, as Dr. Kenneth K. Landis, professor of geology, University of Michigan, contends in his recent study on limestone reserves, which we request be included in the record of this hearing.

Dr. Landis concludes that "the discovery of new high-grade deposits is becoming increasingly difficult and expensive," largely since this grade of stone comprises only 2 to 3 percent of known stone reserves.

3. Industry cost-price squeeze: Bureau of Mines statistics bear out the fact that limestone is one of the country's most uninflated commodities. For example, in the 10-year period between 1957 and 1967, the average mill price for all limestone advanced by only 3 percent, from $1.34 to $1.38 per ton. During this period, cost of capital equipment and labor gained 50 percent.

The only possible explanation for this paradox is that the industry mechanized greatly, increasing its output per man-hour, and the unremitting competitive pressures that exist.

Considerable by-product limestone sales depress prices. The resulting effect of the cost-price squeeze on profits is obvious.

The limestone industry is not big. The total FOB plant value of all crushed limestone produced in 1967 was only $783 million, less than the sales income of just one of any of the 191 largest corporations in the United States during that year. So proportionately a cut in depletion rates hurts our industry much more than the corporate giants.

4. Risks in operation. Limestone quarries and mines are beset with most of the hazards characteristic of the mining industry plus a few more that are unique to limestone. These include flooding, irregularities or faults in limestone deposits, soaring transportation costs that exceed mill prices, and increasingly stringent specifications for our products. Solution of these problems, as we detail in our prepared statement, are either very costly or insurmountable, causing a number of producers to close down each year.

Rezoning in recent years has proved to be an increasing boobytrap for producers located near large metropolitan areas. The limestone operation may have originated in a rural environment but today many quaries find themselves surrounded by expensive suburban homes, high-priced apartments and so forth. Harassed by city officials and property owners, the limestone operator decides to move farther out to stone reserves he has owned for some time, but to his dismay, he finds that his land has been recently rezoned as nonconforming for quarrying, even though his land purchase predated the rezoning.

He then finds sky-rocketing land values in country estates farther out making exploitation economically unprofitable. Other hitherto available lands with good stone have been removed by governments for national parks, interstate highways and so forth.

Urbanization has irrevocably moved some high-grade limestone deposits from exploration. My native Philadelphia is an example, and so is Chicago.

Another major problem we must face is air pollution. With the State and Federal drive against air pollution, limestone companies are being forced to invest heavily in elaborate dust control equipment and systems, in order to comply with recent stringent air pollution standards on particulate matter. In extreme cases the capital investment involved to conform to the exacting dust control standards approximates one-fourth of the total plant investment.

In conclusion, let me say that a reduction in depletion rates on limestone at the present time could not be more poorly timed. With the many industry problems I have cited, limestone needs profit stimulation, not a financial penalty in order to justify the many risks inherent in this business.

Accordingly we respectfully ask you to restore to the tax reform bill the current 15-percent depletion rate on limestone as well as the 5-percent rate on construction aggregates, in which limestone also plays a major role.

In so doing the best interests of the country and the limestone industry will be served.

Thank you.

The CHAIRMAN. Thank you very much.

Senator MILLER. May I ask if your association or if your members make sales of agricultural limestone?

Mr. CORSON. Yes; we do.

Senator MILLER. What is the total annual gross sales by your association, and the estimated depletion allowance on these sales?

Mr. CORSON. We have no breakdown of sales of agricultural limestone by the members of National Lime Association. Stone sales for agricultural uses are not a very large factor in our small segment of the stone industry. On an overall basis, however, we would guess that the amount might be in the neighborhood of 5 to 10 percent of our members' sales of limestone products. Based upon Minerals Yearbook price information for 1967 and our rough estimate that our members produce around 7 million tons of agricultural limestone a year, the gross sales would be around $12 million. The estimated depletion allowance on such sales would be approximately $1.3 million, assuming the nonapplicability of the 50 percent of net income limitation.

Senator MILLER. Could you give us a breakdown on total stone sales by category, and how your members fared financially?

Mr. CORSON. Because of the highly competitive nature of the lime industry, statistics on total stone sales by category and net profits of the members of the National Lime Association are not available. Based upon Minerals Yearbook figures for 1967, we would estimate that the present 15-percent depletion allowance on high-grade limestone used for chemical and metallurgical purposes would give an annual depletion allowance of around $19 million without regard to 50 percent of net limitation.

Senator MILLER. How would the reduction to 11 percent affect you?

Mr. CORSON. Based on such data, a reduction in the rate of depletion from 15 to 11 percent would adversely affect the producers of high-quality limestone for chemical and metallurgical uses by an estimated $5 million a year. For agricultural stone sales of our association members, the reduction in percentage depletion of an estimated $500,000 a year could result in higher prices to farmers if the increased cost is passed on.

Senator MILLER. Thank you, Mr. Corson.

Senator FANNIN. Just how do we use limestone?

Mr. CORSON. I have a small table here. Based upon Minerals Yearbook data, the approximate breakdown of limestone in 1967 by end use category is as follows:

	Millions of tons
Concrete and roadstone (aggregate)[1]	375
Agriculture	30
Chemical and metallurgical[2]	72
Other industrial[3]	100
Refined fine aggregate[4]	3
Total	580

[1] Includes railroad ballast, riprap, and fill.
[2] Includes all metallurgical fluxing for steel and nonferrous metals; stone for lime manufacture; whiting; glass; paper; animal feeds; refractories; chemical manufacture, etc.
[3] Largely for cement manufacture, but also includes coal mine dusting, filtration, acid neutralization, mineral wool insulation, etc.
[4] Includes asphalt filler and limestone sand.

Senator FANNIN. Thank you, sir.

Mr. CORSON. Could I give two samples of chemical metallurgical limestone so you might examine them? These are both polished but they show the lack of impurities and the pureness of the stone and I think they might be interesting to the committee.

The CHAIRMAN. Are both of those pure or just one of them?

Mr. CORSON. Both. Both will run over 98 percent calcium carbonate.

The CHAIRMAN. Senator Anderson has some questions.

Senator ANDERSON. You indicated how many firms are going under.

Mr. CORSON. I am sorry?

Senator ANDERSON. Can you furnish us with the firms that are having trouble?

The CHAIRMAN. A list of the firms in your association that are having difficulty making ends meet.

Mr. CORSON. We will supply that.

(The following response for the record was received from Mr. Corson:)

It would be inappropriate for us to list on the public record the names of members of our association or industry who are presently hard-pressed financially. However, we estimate that at least 20 to 25 plants have been closed due to either bankruptcy, exhaustion of stone deposits or other insurmountable problems in recent years. If desired, we could list the name and location of such plants for use by the committee in executive session but not for publication.

The CHAIRMAN. Thank you, sir.

(Mr. Corson's prepared statement, with an attached statement of Kenneth K. Landes follows:)

STATEMENT OF THE NATIONAL LIME ASSOCIATION, PRESENTED BY PHILIP L. CORSON, CHAIRMAN, TAX COMMITTEE

SUMMARY

H.R. 13270 ("Tax Reform Act of 1969") would reduce the 27½% oil depletion allowance to 20% and prohibit its use on foreign oil production. Apparently almost as an afterthought (and certainly without adequate hearings on the subject) the Ways and Means Committee also included in H.R. 13270 a provision reducing the percentage depletion rate for all other minerals—other than gold, silver, oil shale, copper and iron ore mined from deposits in the United States—by amounts roughly proportionate to the reduction in the rate for oil. As a consequence, H.R. 13270 would generally reduce the depletion rate for limestone from 15% to 11%, with the reduction being from 5% to 4% where the limestone is used as road stone or for similar purposes.

Reasons for Opposing Drastic Reduction in Depletion Rate for Limestone When Used as Other than Common Stone

1. High quality limestone is indepensable in the manufacture of iron and steel and in the beneficiation of copper ore and copper refining. For example, on the average, about ⅓ ton of limestone is required to produce one ton of steel. It is difficult to reconcile no cut in the depletion rates for iron and copper ores when limestone is slashed. All these basic materials should be given equal treatment with their current 15% rate maintained.

2. Known reserves of high quality ("metallurgical grade") limestone in this country are in relatively short supply. This grade of limestone comprises only 2% to 3% of known limestone reserves. The discovery of new deposits is becoming increasing difficult and expensive.

3. The limestone industry for at least the past ten years has been experiencing slender and narrowing profit margins because of a cost-price squeeze in the industry. A substantial cut in the depletion allowance for this strategically important industry, because of the public clamor for cutting oil and gas depletion rates, is both unfair and short-sighted.

4. In addition to the cost-price squeeze, there are many deterrents to limestone exploration and development, including necessary expenditures to comply with air pollution standards. As a consequence, reduction in depletion rates on limestone at the present time could not be more poorly timed.

STATEMENT

The National Lime Association wishes to protest the proposed cutback in the depletion rate on limestone embodied in the Tax Reform Bill, H.R. 13270. We will greatly appreciate your serious consideration of the following arguments in support of our position. The protestant is a national trade association, representing over 85% of the U.S. commercial lime industry production capacity. Its products are quicklime and hydrated lime made by calcining at high temperatures high quality limestone. Members of the association also sell crushed and ground limestone to the metallurgical and chemical process industries and for other purposes.

High grade limestone

For lime manufacture and for the metallurgical and chemical uses. the highest quality of stone is demanded to satisfy stringent specifications on purity. Generally such limestone must meet a minimum of 95% total carbonate content (calcium carbonate plus magnesium carbonate). In some regions the minimum total carbonate content specified is 97% or even 98%, in addition to maximum tolerances on specific impurities, such as silica, iron, and sulfur.

Essentiality of limestone: Unappreciated by the layman is the basic essentiality of limestone and its first product—lime—to modern industry. Directly or indirectly limestone, as stone or lime, enters into the manufacture of most finished products and many other basic commodities. It is low cost, unglamorous, and taken-for-granted, but it is one of the few most basic building blocks around which industry revolves. In most instances its uses are vital and irreplaceable.

Iron and steel

Limestone is indispensible in the manufacture of iron and steel as a flux (purifier) in which impurities are removed as a molten slag. There are no substitutes, at least, that are even remotely economically feasible. In addition dolomitic limestone and lime are required as refractory materials. A vast tonnage of limestone (as stone) and as lime are used annually by the steel industry. In 1967, according to the U.S. Bureau of Mines, 41.3 million tons of limestone (as stone and its equivalent as lime) were consumed by the U.S. steel industry as follows:

	In millions of tons
Blast Furnace flux	21.06
Open Hearth flux	3.80
Misc. flux: foundries, cupolas, electrics	2.88
Dol. limestone refractory	.46
for lime flux [1]	9.36
for dol. lime refractory [1]	3.76
Total	41.32

[1] Since 2 tons of limestone are required to make 1 ton of lime, the lime figures were doubled for conversion to a limestone equivalent.

Since 127.4 million tons of steel were produced in 1967, from the above limestone total it is apparent that nearly ⅓ ton of limestone was required per ton of steel. Since it is as essential as iron ore for pig iron and steel, it is difficult to reconcile that no cut in the depletion rates is proposed for domestic iron ores when limestone is ignored. Where is the equity in such treatment? Both of these basic materials should be given equal treatment with their current rates of 15% maintained.

Other industrial uses

In addition much lesser (but significant) tonnages are required in the beneficiation of copper ore and copper refining; for the manufacture of alumina and magnesia from which metallic aluminum and magnesium are obtained by reduction. Lime is even employed in the concentration of gold and silver ores and other non-ferrous metals. Again, a cut in depletion rates is avoided for copper ore. Yet limestone and lime are also essential to the manufacture of copper. Similarly gold and silver ores are proposed to be exempt from a rate cutback. yet lime is used in the winning of these metals.

In chemicals manufacture it is required in the Solvay process for soda ash and caustic soda manufacture; for calcium carbide, an important source of acetylene; for many calcium inorganic and organic salts, i.e., phosphates, hypochlorites, stearates, etc; pesticides; paints and protective coatings.

It is essential in glass manufacture. Next to sand, limestone-lime and soda ash, are the major raw materials used in glass. Lime is essential to the sulfate (kraft) process for paper pulp manufacture, and limestone whiting is used for paper coating and as a filler. Lime is required for municipal water purification and softening and in sewage and industrial waste treatment processes to reduce stream pollution. All sugar manufactured requires lime; the limestone factor in a ton of beet sugar is nearly ½ ton. It is the major ingredient in animal feed to provide calcium. There are many other uses. In the growing movement to arrest air pollution limestone and hydrated lime may offer possibly the most economical method of absorbing sulfurous fumes from industrial exhaust gases through neutralization. If this materializes, expanded quarry operations would be required to satisfy this huge new demand.

Thus, it is apparent that without high grade limestone modern industry would cease, and in time of war it is just as strategic as steel, iron ore, petroleum, and coal. This fact was specifically recognized by Congress during the Korean War when chemical and metallurgical grade limestone was exempted from the Excess Profits tax as a strategic mineral. Thus, for defense and our civilian economy it is clear that this industry should be encouraged.

Relative scarcity of high grade limestone

The foregoing metallurgical and chemical uses of limestone and lime that demand high purity stone total currently about 72 million tons per year. Such a massive annual withdrawal of our natural resources obviously depletes the existing deposits. Limestone is no different from any other mineral; its quarries and mines also are exhaustible. To replace exhausted deposits, systematic costly geologic exploration and exploitation is essential.

Attached to this testimony is a report by Dr. Kenneth K. Landes, Prof. of Geology, University of Michigan entitled "Metallurgical Limestone Reserves in the U.S." (2nd edition). In this report Dr. Landes delineates the principal areas of the country that are the sources of high grade limestone and outlines the problems encountered in exploration work. He concludes that "the discovery of new deposits is becoming *increasingly difficult* and *expensive.*" This grade of limestone comprises only 2% to 3% of known existing limestone reserves. Dr. Landes is regarded as this country's foremost authority on limestone exploration and reserves and he has spent over 40 years in investigative work on limestone.

Cost-price squeeze

As evidence of the highly competitive nature of the limestone business, the average FOB price of crushed and broken limestone for all purposes only advanced 3% in the 10-year period from 1957 to 1967, according to the U.S. Bureau of Mines.[1] When the prices of nearly all commodities were soaring, many alarmingly so, during this inflationary decade, it must mean that the price of limestone is about the most uninflated of all U.S. commodities. The specifics on comparative limestone prices between these two years is set forth as follows:

Average f.o.b. price per net ton in bulk

Use category:	*1957*	*1967* [1]
Concrete and roadstone	$1.32	$1.32
Metallurgical flux	1.42	1.52
Agricultural Liming	1.66	1.76
Lime manufacture	1.50	1.73
Sugar refining	2.39	2.38
Asphalt filler	2.60	3.00
Glass manufacture	2.98	3.33
Average for all limestone	1.34	1.38

[1] Current (1969) average prices are estimated to be close to 1967 figures, perhaps 2 percent higher.

During this same period labor and capital equipment costs soared about 50% for this industry. The only explanation for this paradox is that the industry mechanized considerably during this period, increasing its output per manhour. This and the unremitting competitive pressures peculiar to this industry can be the only possible explanation. Considerable by-product limestone acts as a de-

[1] 1957 Minerals Yearbook, p. 1095, 1967 Minerals Yearbook, pp. 1081–2.

pressant on prices. In balance it means that the industry has been working with slender and narrowing profit margins.

The typical limestone producer is often a small manufacturer, usually a family-owned or closely-held company. The impact of a cut in depletion rates would hurt him proportionately much more than the large corporations and conglomerates that are protected by diversification. The total FOB plant value of *all* crushed and broken limestone produced in the U.S. was only $783 million in 1967, less than the income of just one of any of the 191 largest corporations[2] in this country during that year. Yet the country for strategic reasons needs the output of our relatively small industry.

Risks in limestone extraction

Limestone operations are often beset with most of the hazards characteristic of the mining industry. Following are the principal problems encountered, the solutions of which are usually either very costly or insurmountable forcing each year a number of producers to abandon their business.

1. *Flooding* of quarries and mines will occur from underground springs and streams or torrential rains. In many cases continuous or intermittent pumping at considerable cost will control this problem, but there have been many quarries abandoned due to inability to adequately control flooding or the costs involved proved to be prohibitive.

2. *Irregularities* in limestone deposits is a continuing problem. In the direction of the quarry or mine expansion or strike, abrupt *faults* may occur in the deposit or thick layers of impure or unsalable stone or shale may be encountered overlying the desired stone. Stratas of *overburden* will frequently deepen to the point that the cost of stripping the deposits becomes prohibitive. Due to these situations that even with the most prudent geologic and engineering practices are not always predictable, drastic revamping of the quarry layout is often necessary. Frequently the only economical solution is to start over afresh and develop a new deposit at another location, but the same risks may prevail at the new location.

3. Sudden increases or changes in the competitive status quo of *transportation costs* can create an economic crisis for some limestone producers. Being such a low cost commodity, the shipping range is much more restricted than with most commodities, and transportation costs will range from 50% to 250% of the mill price of the material. As an example, the sudden emergence of low-cost water transportation can cause certain producers, dependent on higher-priced rail or truck traffic to lose their major markets. A producer, who has to move to another quarry 10 to 20 miles farther away from his processing plant and railhead due to insurmountable problems encountered, may find the added transportation costs attendant to this move more than he can absorb.

4. Changes and tightening of quality *specifications* on limestone can render deposits obsolete and force companies out of business. As an example, a consumer may decide that it must have limestone with a lower sulfur content (from 0.1% to 0.05%) or higher carbonate content (from 95% to 97%) even though it will cost him more. Unless the current limestone supplier can beneficiate his stone to meet the more exacting specifications, he may face a serious loss of business that in some cases can be disastrous.

5. *Rezoning* in recent years is proving to be an increasing booby-trap for producers located near large metropolitan areas. 15 to 20 years ago such problems could not be reasonably anticipated, but then who could have foreseen the tremendous growth of many urban areas as suburbs began inundating the adjoining rural areas forming satelite cities and more suburbs with their complex shopping centers, beltways and cloverleafs that absorbed great chunks of land.

The limestone operation that was built up in a farming environment may be today surrounded by expensive suburban homes, high rise apartments, and shopping centers. The noise from blasting, dust, and truck traffic irritates the new residents, who along with public officials harass the limestone operator as a nuisance. If the operator decides to move his plant to a new quarry site a few miles away on property that he has owned as a strategic limestone reserve, he may find that even this area may be zoned as non-conforming for industrial operations, like limestone, even though his purchase of the land greatly pre-dated the zoning.

[2] Fortune magazine corporate statistics.

Deterrents to limestone exploration

There are, of course, untouched deposits of high grade limestone that can never be exploited, at least, in the foreseeable future. The deposits are too small or are of marginal quality and do not justify the capital investment for exploitation. In other instances, are located too deep under the earth or they are located in remote, inaccessible areas where transportation problems are insurmountable and markets too distant.

However, in recent years increasingly lime operators have been denied other potentially productive limestone properties. Land located in or on the fringe of the burgeoning suburbs that only a few years ago was rural is now zoned nonconforming to industrial business, like limestone, chemical or heavy industry. Philadelphia and surrounding cities and the Chicago area have thousands of acres of land underlain with high quality limestone that are irrevocably committed to urbanization and blanketed with high cost housing, shopping centers, schools, etc.

Beyond urban areas are large country estates, country clubs, etc. where land values have skyrocketed so high in recent years that it is increasingly uneconomic for limestone exploitation. High acreages have been retired in recent years from public use for national and state parks, some of which have otherwise exploitable limestone deposits. The vital interstate highway program with the huge acreage it has devoured has similarly reduced exploration prospects.

Air pollution problems

In addition with the state and federal drive against air pollution, limestone companies are being forced to invest heavily in elaborate dust control equipment and systems in order to comply with recent stringent air pollution standards on particulate matter. In extreme cases the capital investment involved to conform to the exacting dust control standards approximates one-fourth of the total plant investment.

Conclusion

Consequently, a reduction in depletion rates on limestone at the present time could not be more poorly timed. But with the many problems described above, this industry needs profit stimulation, not a financial penalty, to justify the many risks inherent in this business.

Accordingly, we respectfully ask you to restore to the Tax Reform Bill the current 15% depletion rate on limestone as well as the 5% rate on construction aggregates, in which limestone also plays an important role. In so doing, the best interest of the country, as well as the limestone industry, will be served.

METALLURGICAL LIMESTONE RESERVES IN THE UNITED STATES (SECOND EDITION)

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The National Lime Association
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ILLUSTRATIONS

SUMMARY AND CONCLUSIONS

High quality ("metallurgical grade") limestone is just as essential to the making of steel as iron ore; it is also necessary for the burning of lime and for the manufacture of many chemicals. Limestone, the rock, is common and abundant in the United States, but metallurgical stone constitutes only a very small part of the total volume of limestone rock. It is a valuable, essential, and exhaustible mineral resource.

Metallurgical stone occurs in deposits within geologic formations. Geologic maps show the areas of outcrop of formations and groups of formations, some of which are notable for their high quality limestone deposits. It should be observed, however, that the workable deposits themselves occupy but an insignificant part of the total area covered by the formations. In many places where a formation is mapped, erosion has stripped away all of the good stone, or due to environmental conditions at time of deposition good stone was never present in this area, or the overburden is too thick for removal, or the good stone is too deeply buried beneath poor stone to permit profitable exploitation.

The popular concept of an unlimited supply of limestone must be abandoned so far as metallurgical grade stone is concerned. Every metallurgical limestone quarry or mine today is working a deposit which has definite boundaries, either physical or economic, or both, beyond which exploitation cannot go. Many of these deposits will reach those boundaries within the next ten years. The writer of this report, who has been investigating limestone deposits in various parts of the United States during the last 37 years, knows of only two metallurgical grade limestone deposits that he believes will still be yielding metallurgical stone 50 years hence. Of course, new deposits will be discovered in the future as in the past, but their discovery is becoming increasingly difficult and expensive.

The conclusion is inescapable that metallurgical limestone is a valuable natural resource occurring in deposits definitely limited as to recoverable volume. Each year's withdrawals from a deposit of metallurgical grade limestone <u>exhaust the value of the property</u>.

July, 1963

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DEFINITIONS

Some words have different meanings to different people. In many instances the same word may have a much more restricted meaning to the scientist than it has for the man in the street, and even for the man in industry who may use the word constantly. Therefore, in order to avoid confusion some of the more common terms used in this report are defined in the following paragraphs as they are used herein. For practical reasons the terminology followed tends to favor the trade usage rather than the academic definition.

Limestone. The word "limestone" without qualifying adjective as used in this report is a sedimentary rock composed largely of the mineral calcite (calcium carbonate) or the mineral dolomite (calcium-magnesium carbonate) or mixtures of the two.

High calcium limestone. A limestone consisting dominantly of the mineral calcite. When the term "limestone" is used in scientific reports, high calcium limestone is implied.

Dolomite. Limestone rock composed chiefly of the mineral dolomite (calcium-magnesium carbonate). Limestones which are mixtures of the minerals calcite and dolomite may be referred to as "dolomitic limestones" or "magnesian limestone." Where the end use does not depend upon the chemical composition dolomitic rocks are referred to as a limestone in accord with the first definition above.

Carbonate rock. A very convenient term to include all stone covered by the three preceding definitions. It is derived from the fact that both calcite and dolomite are carbonate minerals.

Metallurgical stone. A term applied to all carbonate rocks which are used as a flux in metallurgical processes, such as in the blast furnace to assist in the conversion of iron ore to pig iron and in the open hearth furnace where pig iron becomes steel. Dolomite is also used as a refractory in furnace linings. As can be seen in Table 1 both high calcium limestone and dolomite have metallurgical uses.

Chemical stone. Carbonate rock that is used by the chemical industry.

Lime. The product obtained by heat treatment in a kiln of either high calcium limestone or dolomite. The heat treatment drives off carbon dioxide leaving either calcium oxide or the oxides of calcium and magnesium (in the case of dolomitic raw material).

Lime is sold either as quicklime which unites vigorously with water, or the water is added prior to sale in which case it is marketed as hydrated lime.

Cement stone. A high calcium limestone which can be used in the manufacture of cement. Portland cement specifications limit the amount of magnesium oxide to 5% which means that the raw material cannot run over 3%. However, argillaceous (clay) impurities may be present up to about 25%; in fact if they are not present in adequate proportion in the rock, clay or similar raw material from outside sources has to be added.

Commercial stone. Stone used in concrete aggregate and as road metal. Also referred to as "road stone".

Place value. Limestone, even that of highest grade, is a bulk commodity with a relatively low value per ton. In consequence most limestone buyers pay more for transporting the raw material than the cost of the stone at its source. For this reason limestone as well as other mineral bulk commodities are said to have "place value". A high-grade limestone in Montana would have very low place value, the place value of a limestone of equal grade in eastern Iowa would be much higher, and such a stone within the city limits of Chicago would be at the very top in place value.

USES AND SPECIFICATIONS

Usable and not usable limestones. Both high calcium limestone and dolomite which can be used for metallurgical and chemical purposes are scarce in terms of the total volume of limestone within the United States. Somewhat larger, but still limited in volume, is the limestone that can be used commercially, mainly for concrete aggregate and as road metal. The remaining limestone is either too impure chemically or inadequate physically for any use whatsoever. Wherever there are limestones this completely non-usable stone is by far the most abundant, occupying many cubic miles of the earth's crust.

Metallurgical limestone specifications. Limestones that are satisfactory for metallurgical or chemical uses as stone, or satisfactory for raw material for the production of calcined products, may be classified in four grades as follows:

Table I

		A-1	A-2	B-1	B-2
Silica	less than	1.0%	3.0%	1.0%	2.0%
Alumina	" "	1.5	1.5	1.5	1.5
Sulfur	" "	0.1	0.1	0.1	0.1
Magnesia	" "	5.0	5.0	21.8	21.8

These specifications are arbitrarily made to provide a means of identifying various classes of limestone since there are no generally agreed upon standards. Silica, alumina and sulfur are impurities. Magnesia is an active basic agent, but limestones with varying proportions of magnesia may have different uses.

Uses of metallurgical stone. Over half of the total volume of stone here classified as "metallurgical" consumed annually is used as blast furnace flux. The blast furnace is the fundamental unit in the conversion of iron ore to pig iron. An average of 800 pounds of limestone is used in producing each ton of pig iron. The function of the flux is to furnish basic constituents, namely lime and magnesia, which will combine with the acid compounds normally present in an ore, such as silica and alumina, and remove them in the form of the resulting slag at the top of the molten metal in the blast furnace. Also the flux is very important in the removal of sulfur present in the coke in the blast furnace charge. Because the efficiency of the flux is dependent upon the amount of basic elements it can contribute, it becomes obvious that the presence of such compounds as silica and alumina in the flux itself serves to reduce the effectiveness of the flux as a metallurgical agent. It is, of course, possible to compensate for these increases in acid compounds in a flux by the addition of more flux. However, this practice has its limitations because it not only increases the slag volume, decreasing the furnace capacity, but in addition more coke is required to heat the additional stone to flux the acid compounds already in the stone and further, the addition of more coke to a blast furnace means that more impurities present in the coke have to be fluxed as well. Therefore, grade A-2 stone is used only where the delivered cost of A-1 stone is more than the additional costs involved in using an A-2 fluxstone obtainable near by.

The presence of magnesia does not seem to interfere with the fluxing property of limestone; in fact some blast furnace operators specify from 5 to 9% MgO in the belief that with such stone they obtain a more satisfactory slag. Therefore, B-1 (and even B-2) grade stone may be used either directly as a blast furnace flux, or as a supplementary material to be added to the A-1 charge.

Metallurgical stone can only be used in lump form. The fines produced during mining and processing must be agglomerated or marketed elsewhere. Pulverulent types of limestone such as chalk and marl cannot be used for metallurgical purposes, regardless of purity, unless agglomerated.

Most of the conversion of pig iron to steel is done in the open hearth furnace. During this operation from 130 to 370 pounds of flux, depending upon the amount of phosphorus that has remained in the pig iron, is added for each ton of steel produced. A-1 (or A-2) grade stone is used for this purpose; the dolomitic limestones (B-1 and B-2) are not used.

Dolomite is refractory and is used in lining basic open hearth steel furnaces. Only B-1 grade, and that at or close to the pure dolomite end of the calcium-magnesium series, can be used.

One of the most important uses of calcined limestone (lime) is as a flux in the production of steel. Chemical stone, used in making such products as soda ash and calcium carbide, and in the refining of beet sugar, must be of A-1 grade in most instances, although B-1 stone is used in quantity for some purposes. Quality plasters can be made only from A-1 or B-1 stone.

The utilization of the various grades of limestone as metallurgical stone is summarized in the following table:

Table II

Grade	Blast Furnace Flux	Open Hearth Flux	Furnace Linings	Lime	Chemicals
A-1	Yes	Preferred	No	Yes	Yes For more uses than B-1
A-2	Yes	Yes	No	No	No
B-1	Yes Usually as a supplement to A-1	No	Yes	Yes	Yes
B-2	Yes	No	No	No	No

The total metallurgical grade stone production is roughly one-eighth of the annual domestic crushed limestone produced (the amount of limestone mined for building stone is relatively insignificant). The remaining seven-eighths of the crushed stone has many uses, especially in concrete and road metal, and as cement stone.

It can be seen from the above table that either nearly pure high calcium limestone (A-1) or nearly pure limestone composed chiefly of the mineral dolomite (B-1) are essential to practically all metallurgical operations except in fluxing the blast furnace charge where A-2 (or B-2) quality stone can be used if necessary. Only the B-1 stone can be used as refractory material for steel furnaces.

Variations in quality in natural deposits of limestone. Nearly pure deposits of high calcium limestone (A-1) or dolomite (B-1) are due to a combination of favorable geological conditions both at time of deposition and subsequently. The sea in which the carbonate minerals were being deposited must have been clear; no streams on nearby land surfaces were bringing in sand, silt, or clay particles to be deposited contemporaneously with the carbonate grains. Subsequently no circulating ground waters precipitated silica or sulfides in that particular rock.

Limestones vary in quality both vertically and laterally. Vertical changes are the result of changed environments in the geological past. Just as a limestone may be succeeded by a shale, sandstone, or other rock due to different conditions of deposition at different times, so may a pure limestone be succeeded by a highly impure limestone (such as a shaly or cherty limestone). Likewise limestones vary laterally in purity due to different environmental conditions at time of deposition, or due to more active ground water circulation subsequently. Lateral variations are not as sudden as vertical changes. but may be just as complete. Many instances are known of limestones merging into shales and even sandstones laterally.

It may be concluded that a deposit of nearly pure stone is the result of an unusual combination of circumstances and that this combination was in effect locally but not regionally so the deposit is definitely limited in scope. Consequently every deposit of high-grade limestone may be looked upon as a lens. Some lenses are small, covering but a few acres, and others are large, covering several square miles. Many metallurgical stone operations cease, not because the limestone becomes exhausted, but because the high-grade lens within the limestone formation has been worked out.

LIMESTONE PRODUCTION

Quarrying and underground mining costs compared. Most stone is produced in open cut quarries. Underground mining is much more expensive, and is resorted to only where (1) no surface stone of adequate quality is available, and (2) the consuming district is so remote from open cut quarries that local stone can be mined and delivered cheaper.

Because of much cheaper production costs the outcrop deposits of metallurgical limestone constitute the number one domestic reserve. This stone carries down the regional dip from the outcrop and may underlie, at varying depths, hundreds of square miles of younger rocks. It therefore constitutes a secondary reserve, which will be considered in this report in the discussion on geographical distribution which follows. But it should also be remembered that (1) quality varies laterally, and in many instances A-1 stone in the outcrop becomes A-2 or less pure stone down the dip, and (2) not only does it cost much more to mine stone underground, but those already high costs increase with greater depth so that the potential value of a deeply buried limestone, even though it be of the highest quality, is highly questionable.

Deterrants to continued operation of metallurgical limestone quarries. In many parts of the United States there are dozens of abandoned quarries. Reasons for abandonment follow:

Public pressure. Although a quarry may be started in a rural area and antedate all zoning restrictions, it subsequently may become completely surrounded by residences and subject to harassment by the new neighbors who resent the presence of an industrial plant in their midst even though it was there first. Suits to abate either noise of blasting, plant operation, and truck movement, or dust may lead to the abandonment of a high-grade deposit before exhaustion.

Condemnation for highway and other purposes. Large reserves of high-grade limestone in the Chicago area and no doubt elsewhere have been retired from development through condemnation of a part of the quarry area for expressway use.

Increased thickness of overburden. In quarry operations there is an economic limit due to cost of overburden removal and disposal in order to uncover the stone beneath. When this limit is reached, usually due to increased thickness of overburden as the quarry is extended, the operation must end.

Increased cost with increased depth. This is an especially potent factor in terminating operations in underground mines. In addition to increased operating costs with increased depth every ton of stone produced from a deeper level also has to pay its prorata share of the cost of sinking the shaft to that level.

Pumping costs. Many limestones are very porous and some are even cavernous. Where these limestones lie below the water table either in quarries or underground mines, the pumping expense may eat up the entire profit margin and cause the operation to cease even though high quality stone is still present.

Changes in quality or in quality specifications. As a quarry or mine expands from the original area of operation, relatively slight changes in the chemical character of the rock may make it no longer acceptable to buyers. For example, an increase in the sulfur content of even as little as .01% may shut down an operation. Likewise a tightening of the sulfur requirements by the same amount could have the same effect.

Increased mine to market transportation costs. As with all bulk commodities the major cost is usually transportation. If these costs increase perceptibly the stone may become priced out of its market. Likewise, stone from more distant sources but traveling a cheaper route such as by water, may be able to compete successfully with stone from nearby. For example lake stone (term applied to limestone produced along the shores of the Great Lakes and transported by ship) can move inland for considerable distances invading markets hitherto held by local producers.

Exhaustion of deposit. Many limestone operations have closed down in the past and will continue to close down in the future because exploitation of the deposit has completely exhausted it.

Deterrents to opening up new deposits. Many adequate deposits of metallurgical grade limestone with excellent place value cannot be developed for the following reasons:

Zoning. Zoning restrictions have now spread from the city into the township and even the county. Therefore, in most metropolitan areas today current mining or quarrying operations are nonconforming and no new operations can be initiated even though a company may have owned mineral property for many years within the subsequently restricted area. As a consequence, producers supplying such necessities to urban development as stone, sand, and gravel now have to discover and develop deposits many miles (and many transportation dollars) distant from the concentrated market area.

Urban spread. Even without zoning the ever expanding urbanized area has removed, and will continue to remove, large deposits of limestone from ever being developed. For example, within the last twenty years in eastern Pennsylvania valuable high-grade limestone deposits have been covered by subdivisions, shopping complexes, and drive-ins.

Rural development. Beyond the urbanized zones are large areas covered by country estates and country clubs. The land thus covered is too expensive for acquisition for limestone exploitation.

Parks. Some very large areas are not available for mineral development because they lie within federal, state, or county parks. Examples are wilderness parks, national parks, local parks, parkways, and bird and game refuges. More land is retired for these purposes every year. We even have had recent examples of some states leasing park or game land for mineral development and then refusing the necessary permits to start the development.

Expressways and interchanges. Every year more expressways are built and each year the rights-of-way become wider and the acreage covered by the interchanges becomes greater. Without doubt a considerable tonnage of high-grade limestone becomes no longer available in this manner.

The search for new supplies. Because of the ever expanding market due to increased consumption, and the annual abandonment of many limestone quarries for reasons stated previously, the major limestone producers have to be continuously searching for new reserves. The discovery of such new reserves becomes increasingly difficult because of prior discovery and development, man-made restrictions on areas where stone can be exploited, and the necessity of finding the stone where its transportation cost to market will not be prohibitive.

The search for new supplies is also expensive. Geologists must be employed to locate prospects, land must be optioned, and the prospects core drilled for thickness of overburden and quantity and quality data. It may take months of searching and exploration to obtain a single adequate deposit of metallurgical grade limestone.

DISTRIBUTION OF METALLURGICAL LIMESTONE RESOURCES

Each state in the United States containing significant and accessible reserves of limestone of metallurgical grade is discussed in this section. The state by state summaries are based almost entirely on published information; their accuracy, completeness, and freshness are therefore no better than the quality and dating of the source material. In every instance where specific publications were available on the limestone resources of a state those publications are listed at the end of the pertinent discussion.

Analytical data are not available for many deposits, and the available information is questionable for others. In many instances the published analyses are for isolated "grab" samples which are rarely typical of the deposit as a whole. Only where the deposit has been sampled by the technical methods employed in industry can the analyses be averaged to give a reliable picture of the chemical character of the "run of mine" stone. Where adequate chemical information is lacking the best clues to the quality of a deposit are to be found by a survey of its utilization, including changes in its marketability across the years. Although a premium grade stone may be sold for low quality uses, an inferior stone cannot be marketed for metallurgical purposes, especially in recent years.

It will be noted that some of the references consulted, although the latest available, are of such vintage that the information obtained can hardly be considered up-to-date, especially in regard to areas of current exploitation. However, this report is primarily concerned with the reserve picture, and it can be stated that, as a general rule, the reserve situation has deteriorated instead of improved since the publication of the source data. This has been due to the subsequent exhaustion of many deposits and to the increased quality of stone demanded by the metallurgical market. New discoveries have failed to equal these losses in the metallurgical stone reserve supply.

Ninety per cent of the limestone produced and sold as fluxing stone in the United States in 1961 came from the following seven states:

Rank	State	Production in M tons
1	Michigan	10,565
2	Pennsylvania	4,924
3	Ohio	4,433
4	West Virginia	1,480
5	Alabama	1,269
6	Virginia	972
7	Illinois	737
	Total	24,380

In addition there was considerable production of limestone as chemical stone and for burning chemical lime.

In the following description of metallurgical grade limestone by states, the seven leading states in fluxstone production will be taken up first, in decreasing order of annual output. States of lesser importance as sources of this type of stone will follow, in order of geographic location, from east to west.

All state rankings are based on 1961 production figures as published in the Minerals Yearbook for 1961, Vol. 1, pp. 1157-1158.

Maps are included for the states which supply most of the metallurgical limestone produced in the United States. On these maps are patterns showing the areas in which certain geologic formations, know to contain local deposits of metallurgical grade stone, occur. Two points should be kept in mind in using these maps. First, the pattern refers to the top of the bed rock surface and not to the top of the ground; tens and even hundreds of feet of glacial deposits, wind blown sand, river alluvium, or even deep soil may lie between the surface and the bed rock. Secondly, the commercially usable high-grade deposits occupy only a small fraction of the area covered by a formation pattern, therefore the map does not pinpoint a possible quarry or mine site, but it does give the geologist a less-than-statewide area in which to hunt.

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Michigan

Michigan's rank in the production of metallurgical limestone is due to a combination of strategic location in respect to the Great Lakes waterborne commerce and the presence of high quality stone in unusual abundance. Three formations (Fig. 1), the Burnt Bluff, Engadine, and Dundee-Rogers City are exploited for metallurgical stone in Michigan.

Burnt Bluff formation. The Burnt Bluff formation crosses the southern part of the Northern Peninsula from the Garden Peninsula to the east side of Drummond Island. A large lens of high calcium limestone (A-1) in the Burnt Bluff dolomite is quarried north of Port Inland.

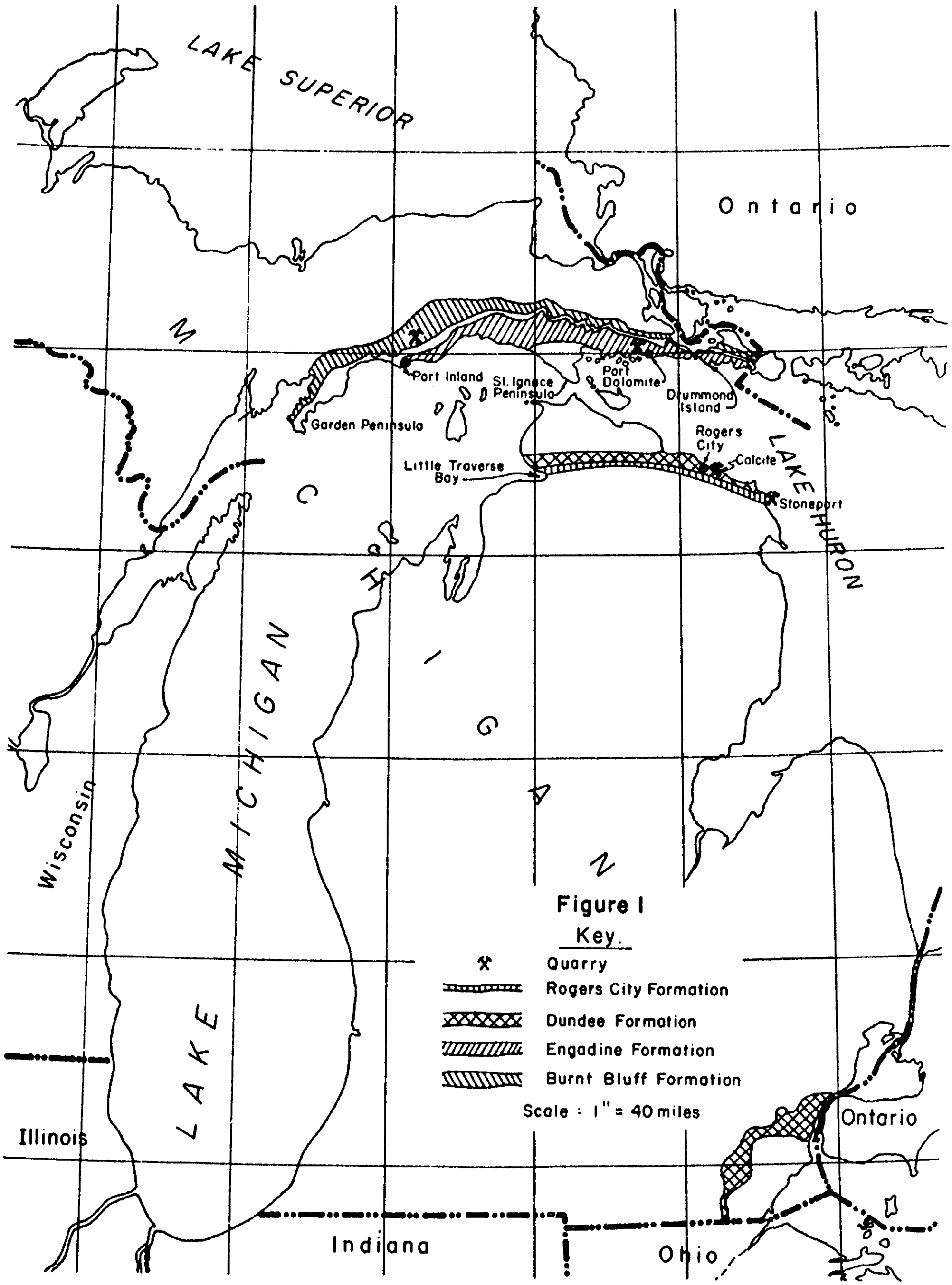
Engadine formation. The Engadine formation at the top of the Niagaran series contains some dolomite of B-1 grade. This formation crops in the Northern Peninsula only, from the Lake Michigan shore near the Schoolcraft-Mackinac County line eastward across the foot of the St. Ignace Peninsula to southern Drummond Island. It is quarried north of Port Dolomite and on Drummond Island. The amount of stone of B-1 grade in this formation is definitely limited by local topography and structural geology. The southerly dip, which carries the Engadine beneath the lake waters in a relatively short distance, makes underground mining virtually out of the question.

Dundee-Rogers City. An exceptionally large deposit of A-1 grade stone lies within the Dundee-Rogers City formations southeast of the town of Rogers City. These rocks are quarried at Calcite and Stoneport. The belt occupied by the Dundee-Rogers City extends from False Presque Isle north and west to Little Traverse Bay. However, west of Black Lake, and perhaps west of Rogers City, the cover of glacial drift is too thick to permit exploitation of the underlying limestone. Down the dip, to the southwest of the outcrop zone between Rogers City and False Presque Isle, the Rogers City-Dundee stone continues beneath successively younger formations. The distance down-dip over which it retains A-1 quality is now known, but it is probable that a large reserve exists in the first few miles basinward from the outcrop. This reserve cannot be tapped, however, until prices justify underground mining.

To the southeast from False Presque Isle the Rogers City-Dundee stone disappears beneath Lake Huron. The Dundee formation reappears in a belt of few outcrops which crosses the corner of southeastern Michigan. Unfortunately, however, this stone loses its A-1 quality between northeastern and southeastern Michigan.

Limestone of metallurgical grade was shipped from the following ports (Figure 1) during the 1961 season:

Port	Formation	Type		Tonnage (M tons)
Port Inland	Burnt Bluff	High calcium		3,591
Port Dolomite	Engadine	Dolomite		2,330
Drummond Island	Engadine	Dolomite		2,048
Calcite	Dundee-Rogers City	High calcium		12,567
Stoneport	Dundee-Rogers City	High calcium		3,552
			Total	24,088


LAKE SUPERIOR
Ontario
MICHIGAN
Port Inland
St. Ignace Peninsula
Port Dolomite
Drummond Island
Garden Peninsula
Rogers City
Calcite
Little Traverse Bay
Stoneport
LAKE HURON
LAKE MICHIGAN
Wisconsin
Figure I
Key.
Quarry
Rogers City Formation
Dundee Formation
Engadine Formation
Burnt Bluff Formation
Scale : 1" = 40 miles
Ontario
Illinois
Indiana
Ohio

During the same year the fluxstone production was recorded as 10,565 M tons, so over half of the lake stone produced was used for other purposes, including as chemical, cement, lime, refractory, and commercial stone.

Michigan contains many other limestone and dolomite beds beside those mentioned, but all other known deposits of adequate size for large scale quarry operations are below A-2 and B-2 grade.

References: K. K. Landes, "Michigan Limestone" subchapter in Chapter 8, "The Carbonate Rocks", in Industrial Minerals and Rocks, American Institute of Mining, Metallurgical, and Petroleum Eng., 1960, pp. 164-167; K. K. Landes, G. M. Ehlers, and G. M. Stanley, "Geology of the Mackinac Straits Region", Michigan Geological Survey, Pub. 44, 1945, 204 pp.; Ralph Melhorn, "Limestone and Dolomite Survey of Mineral Resources along the Pennsylvania Railroad System in Michigan ", Michigan Geological Survey, 1945; Paul C. Morrison, "The Michigan Limestone Industry", Econ. Geog., Volume 18, July 1942, pp. 259-274; R. A. Smith, "Limestones of Michigan", Michigan Geological Survey, Pub. 21, 1915, pp. 103-311.

Pennsylvania

The production of limestone is a major industry in Pennsylvania, and Pennsylvania is a leading state in its annual output of limestone of all types. It is second in metallurgical stone production. Although Pennsylvania is underlain by many cubic miles of carbonate rock, the percentage that is of metallurgical and chemical grade is quite small.

The metallurgical stone resources of Pennsylvania occur in various formations of early Paleozoic age (Ordovician and Cambrian) in central and eastern Pennsylvania and in the late Paleozoic (Carboniferous) Vanport limestone of western Pennsylvania (Fig. 2). Four areas produce most of the metallurgical grade stone from the early Paleozoic rocks, whereas the production of Vanport limestone comes mainly from a single county in western-most Pennsylvania.

Early Paleozoic limestones. The four areas where Ordovician and Cambrian limestones are exploited are (1) Centre and Mifflin Counties in central Pennsylvania, (2) the Lebanon Valley of southeastern Pennsylvania, (3) the Philadelphia dolomite district, and (4) Adams and York Counties, also in southeastern Pennsylvania.

Centre County in central Pennsylvania contains the highest grade limestone (A-1) in quantity in the state. The Valentine formation ("Bellefonte ledge") crops out along the limbs of the Nittany anticline on opposite sides of Nittany Valley. On the northwest flank the beds are vertical, but the southeastern flank dips from 18° to 45°. Although formerly quarried to a considerable extent, most of the Valentine formation now comes from underground mines in the Bellefonte area and across the valley near Pleasant Gap. This stone is used as furnace flux, for chemical purposes, and for lime burning.

The Annville limestone, which like the Valentine is also of Ordovician age, is the A-1 stone which is quarried in the Lebanon Valley of southeastern Pennsylvania. The strata in this area have been tilted beyond the vertical so that they now dip from 30° to 50° south. The Annville likewise is used for lime burning and chemical and metallurgical purposes. In addition some is shipped into the Lehigh Valley cement district for mixing with the local cement rock in order to bring it within magnesia specifications.

Large quarries to the northeast and southwest of Philadelphia produce high-grade dolomite (B-1) from Cambrian rocks. Southeastern Pennsylvania also contains high calcium limestone of similar age. Centers of production are near Hanover in Adams County and in the vicinity of Thomasville in York County.

The east coast steel mills are largely dependent for their metallurgical stone upon the Cambrian dolomite and high calcium limestone deposits of southeastern Pennsylvania. However, both here and in the Lebanon Valley land values are very high and the urban spread westward from the Philadelphia metropolitan area have limited greatly the available reserves for future development.

The Carboniferous Vanport limestone of western Pennsylvania is produced today mainly in the Hillsville-Bessemer district of Lawrence County, but many quarries and underground mines have operated in the past in other parts of the Vanport outcrop area, especially in Armstrong and Butler Counties to the east. The Vanport stone is of marginal quality chemically (mostly A-2) and its furnace use has been due to its place value, lying as it does on the periphery of the Pittsburgh-Youngstown steel district. The Vanport is quite variable in thickness; where exploited it has an average thickness of about 18 feet, but due to erosion prior to deposition of overlying formations this limestone has been cut out altogether in many places. It lies nearly flat, which makes possible quarry operations

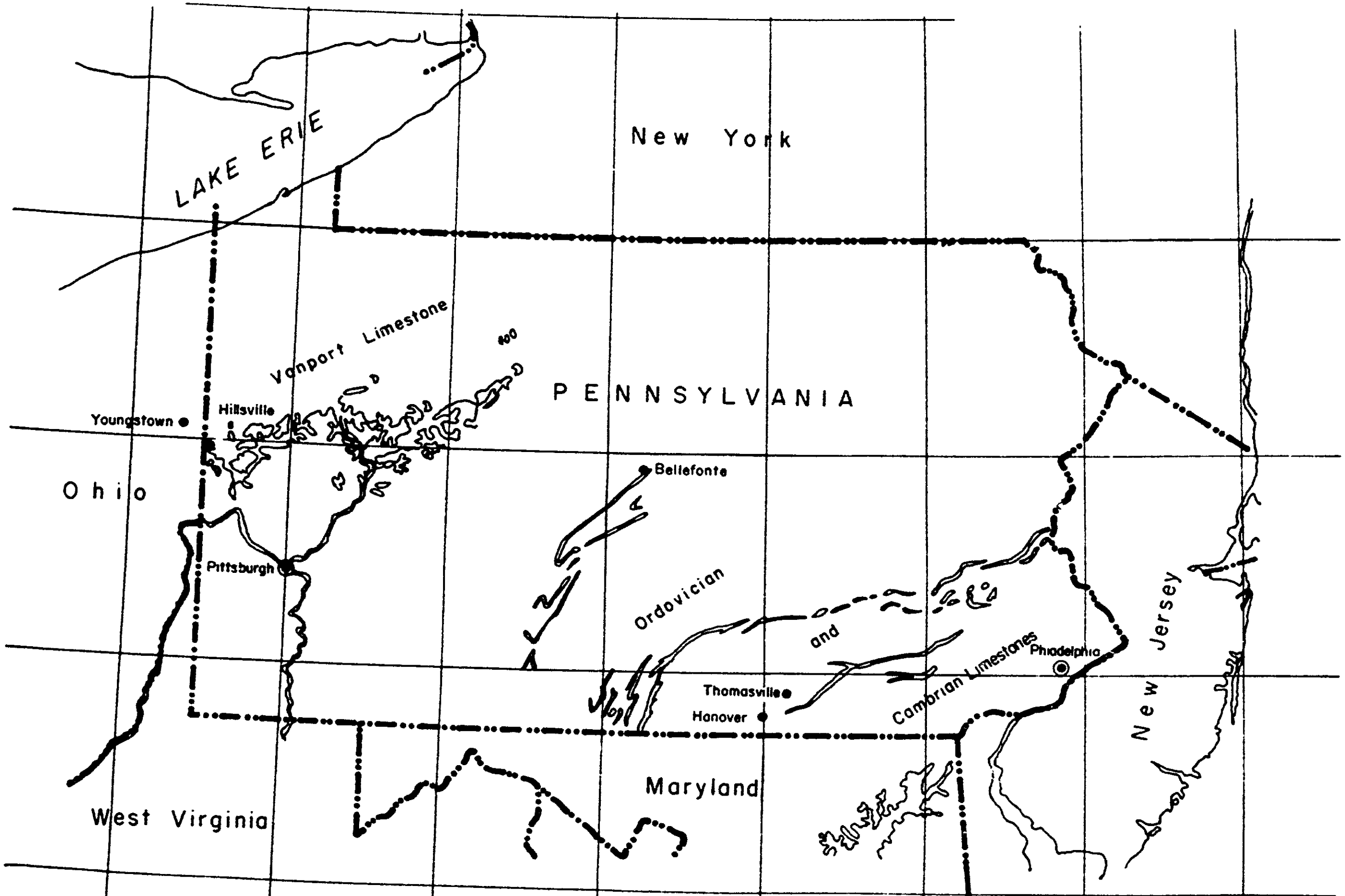


Figure 2
Scale: 1" = 40 miles.

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in the Hillsville-Bessemer area, but farther to the east this ledge crops out along the sides of steep walled valleys so it has been necessary to follow the limestone bed beneath the overlying rock by underground mining in order to exploit it.

References. Frank M. Swartz and Richard R. Thompson, "Commercial Possibilities of Some Ordovician Limestones in Franklin County, Pennsylvania", Pennsylvania State University, Bulletin Mineral Industries Experiment Station, July 1958, 1-14 pp.; Carlyle Gray, "The High Calcium Limestones of the Annville Belt in Lebanon and Berks Counties, Pennsylvania", Pennsylvania Geological Survey, Progress Report 140, February 1952, 18 pp.; Carlyle Gray, "Preliminary Report on Certain Limestones and Dolomites of Berks County, Pennsylvania" Pennsylvania Geological Survey, Progress Report 136, April 1951, 85 pp.; F.M. Swain, "Geology and Economic Aspects of the More Important High Calcium Limestone Deposits in Pennsylvania", Pennsylvania State College Bulletin, Mineral Industries Experiment Station Bulletin 43, 1946, 29 pp.; Marshall Kay, "Chemical Lime in Central Pennsylvania", Economic Geology, Volume 38, 1943, 188-203 pp.; Charles Butts and Elwood S. Moore, "Geology and Mineral Resources of the Bellefonte Quadrangle, Pennsylvania", U. S. Geological Survey Bulletin 855, 1936, 111 pp.; B. L. Miller, "Limestones of Pennsylvania", Pennsylvania Geological Survey, Bulletin M 20, 1934, 729 pp.

Ohio

Ohio ranks third in metallurgical limestone and first in lime production. Two rock groups, the Niagara and the Columbus, are the principal sources of metallurgical stone. The distribution of these rocks in Ohio is shown on Figure 3.

Niagaran dolomite. The only really high quality carbonate rock occurring in abundance in Ohio is the Niagaran dolomite which underlies a considerable area in western Ohio. Local names used for this rock include Peebles, Lilley, Cedarville and Guelph. The best stone appears to be localized in the northern part of the Niagaran outcrop to the southeast of Toledo in the general vicinity of Woodville. Here is the largest lime burning district in the United States. Because of the purity of the dolomite the lime is likewise high-grade and is used in chemical manufacture. Raw (unburned) dolomite is also shipped directly to chemical and steel plants. There is a large reserve of dolomite in the Woodville area, but future development will involve the removal of more and more overburden per ton of stone produced because the localities where thick dolomite lies at shallow depth are being exhausted.

Although the map shows another and larger outcrop band of Niagaran rock, crossing from Indiana into west central Ohio and continuing down to (and across) the Ohio River into Kentucky, most of this stone is B-2 or lower in grade.

Columbus limestone. The Columbus limestone, an A-2 stone, is the principal source of fluxing stone and chemical stone in Ohio. It extends from Kelleys Island in Lake Erie to south of Columbus (Fig. 3). The workable deposits at the north end of this zone have been largely exhausted. Abandoned quarries are numerous both on Kelleys Island and south of Sandusky Bay on the mainland.

As a general rule the Columbus limestone increases in silica and magnesia content with depth, so the downward limit of exploitation, so far as furnace stone is concerned, is an assay level rather than a geologic contact. Chert bands may be present locally at higher levels in the Columbus formation. However, in spite of its marginal chemical character for use as metallurgical stone is concerned, this limestone is so close to major consuming centers that it has unusually high place value.

The Columbus limestone dips to the east from the outcrop band and is mined at a depth of 2248 feet at Barberton, southwest of Akron, for chemical stone. The limestone exploited by this mining operation is also cherty.

Formations not shown on Ohio map. The Vanport limestone of Carboniferous age is extensively quarried in western Pennsylvania (see Pennsylvania) and some of the workings extend across the line into Ohio.

The Brassfield formation, somewhat older than the Niagaran but still of Silurian age, crops out in southwestern Ohio where it is practically the only commercial limestone. Chemically the stone is A-2 in grade. Its exploitation is handicapped by the fact that is has maximum thickness of only about 12 feet, except locally where it may be as much as 20 feet.

Various other formations are quarried in Ohio for crushed stone, but are too impure for metallurgical use.

References. Clinton R. Stauffer, "The Columbus Limestone", Journal of Geology, Volume 65, July 1957, pp. 376-383; Raymond E. Lamborn, "Limestones of Eastern Ohio",

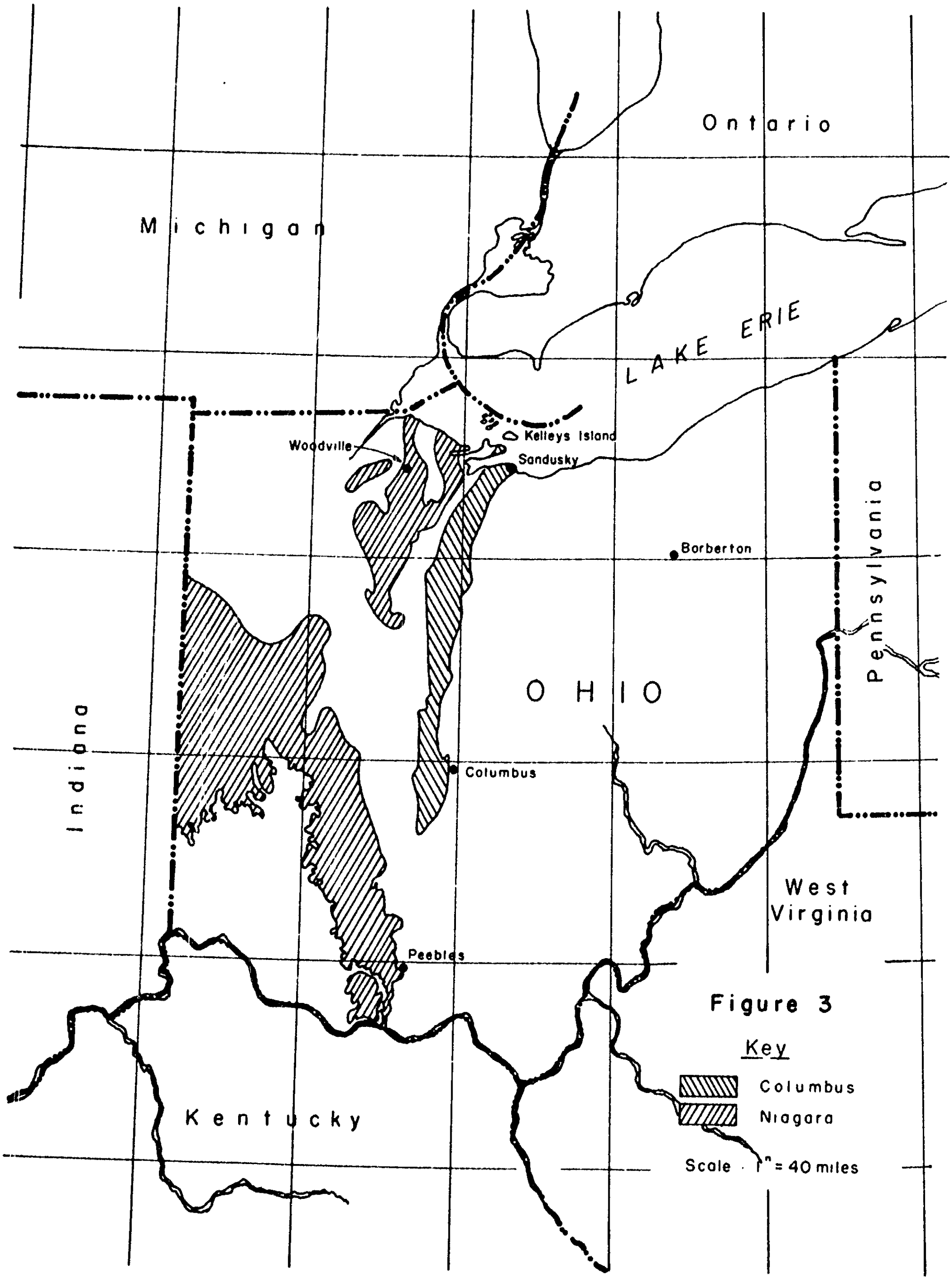

Ontario
Michigan
LAKE ERIE
Kelleys Island
Woodville
Sandusky
Barberton
Pennsylvania
Indiana
OHIO
Columbus
West Virginia
Peebles
Kentucky
Key
Columbus
Niagara
Scale 1" = 40 miles

Figure 3

Ohio Geological Survey, Bulletin 49, 1951, 364 pp.; Clinton R. Stauffer, "The Geological Section at the Limestone Mine, Barberton, Ohio", American Journal of Science, Volume 242, May 1944, pp. 251-271; Wilber Stout, "Dolomites and Limestones of Western Ohio", Ohio Geological Survey, Bulletin 42, 1941, 446 pp.

West Virginia

West Virginia is the fourth state in the United States in annual production of metallurgical stone. In addition to a considerable volume of fluxstone, this state ranks high among the lime producing states, and also produces some dead-burned dolomite for refractory purposes. The metallurgical stone is confined to the Ordovician Mosheim limestone and Cambrian Tomstown dolomite which lie within the band of rocks which cuts across the northeastern or "panhandle" corner of West Virginia between Maryland and Virginia (Fig. 4).

Mosheim limestone. This is the only high quality limestone (A-1) in West Virginia. It crops out in Berkeley County and to a lesser extent in Jefferson County. It averages less than 1% silica and 2% magnesia, and is likewise low in alumina. The Mosheim, therefore, makes a very fine fluxstone and is ideal for lime burning.

Due to close folding and erosion the Mosheim limestone occurs in more or less isolated pockets. Many of the individual deposits have been completely worked out, and other pockets are so small that they cannot be profitably exploited. The volume of Mosheim stone yet to be quarried or mined in West Virginia is relatively small.

Tomstown dolomite. The Tomstown formation is a true dolomite of B-1 rank. Chemical analyses made of samples of this stone obtained from active quarries have shown a uniform silica content of less than 1%. It is quarried in considerable volume for refractory purposes. The center of the Tomstown exploitation is in the vicinity of Millville in Jefferson County. Like the Mosheim limestone the Tomstown dolomite occurs in infolded deposits, many of which have already been worked out and the remainder are definitely limited as to reserves.

References: J. B. McCue, J. B. Lucke, H. P. Woodward, "Limestones of West Virginia", West Virginia Geological Survey, Vol. 12, 560 pp., 1939; G. P. Grimsley, "Jefferson, Berkeley, and Morgan Counties", West Virginia Geological Survey, County Reports, 644 pp., 1916.

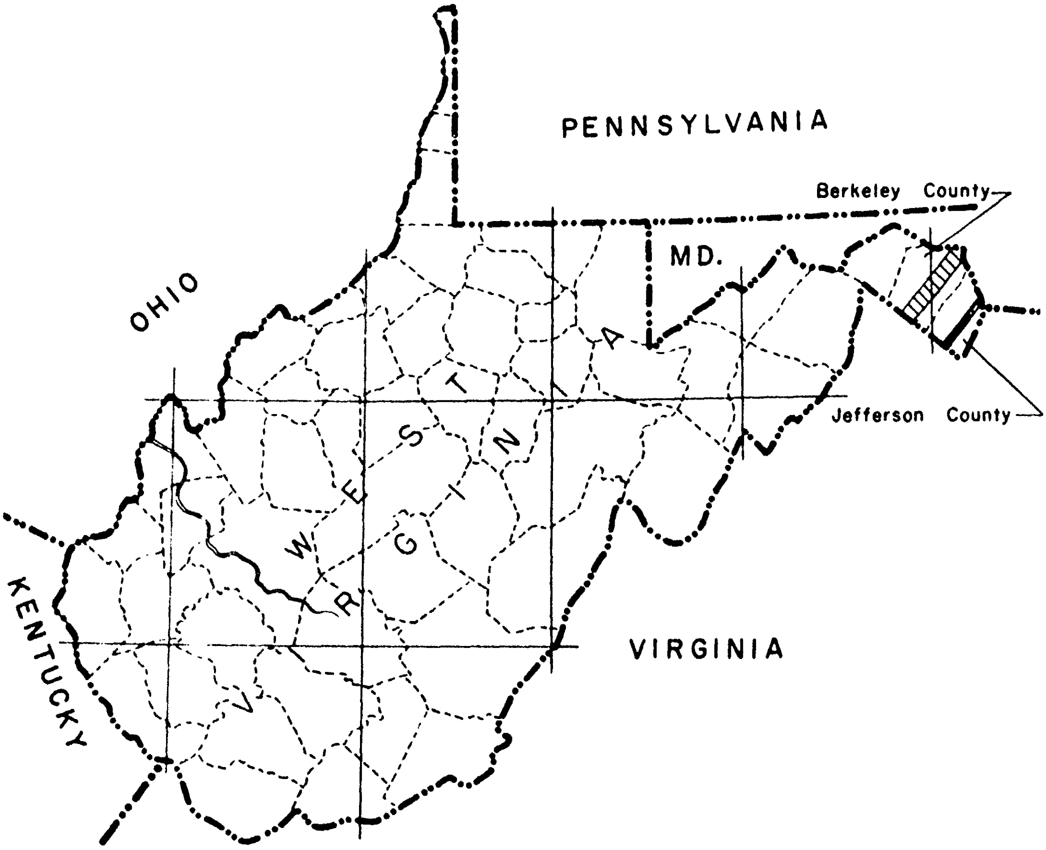


Figure 4

KEY

Mosheim high calcium limestone belt

Tomstown dolomite belt

Scale: 1" = 40 mi

Alabama

Alabama ranks fifth in annual output of fluxstone and eighth in lime. Most of the crushed limestone produced is used for flux in the Birmingham iron furnaces. The Alabama fluxstone and lime rocks occur in both Cambro-Ordovician and Mississippian formations (Figure 5).

Cambro-Ordovician formations. The largest quarries are in the Upper Cambrian Katona (Knox) dolomite in the vicinity of Birmingham. Some ledges run less than 1% silica in carload lots and so qualify for B-1 rating. Some lump dolomite is also mined in this district for refractory purposes. Dolomite and limestone of Lower Ordovician (Beekmantown) age are also quarried, especially in Shelby County, for both chemical and metallurgical uses.

Mississippian formations. Mississippian limestone has been rather extensively mined and quarried in Shelby, Jefferson, Blount, and Etowah counties, for flux in the Birmingham iron district. These limestones are A-2 in grade as a general rule. As yet untapped deposits occur along the Tennessee River in northern Alabama.

References: Hugh D. Palliser, "Alabama", in Industrial Minerals and Rocks, Chapter 8, "The Carbonate Rocks", American Institute of Mining, Metallurgical, and Petroleum Engineers, 1960, pp. 151-159; Benjamin Gildersleeve and James L. Calver, "Guntersville Reservoir Quarry Site Limestone Investigations", Tennessee Valley Authority, April 1943, 95 pp.

Virginia

Virginia is sixth in fluxstone and seventh in lime production. It also has a considerable chemical stone industry. The metallurgical stone resources of Virginia are confined to the upper Cambrian and Ordovician belt of rocks which crosses the western part of the state from northeast to southwest (Fig. 6). Topographically this region is known as the Appalachian Valley and in it are found over thirty lime plants and fluxstone and chemical stone quarries. Both high calcium limestone and dolomite are present in this belt of carbonate rock. Some stone of A-1 and B-1 quality is present, larger quantities of A-2 and B-2 are available, but the greater part of the limestone in Virginia (as elsewhere) is not of metallurgical grade.

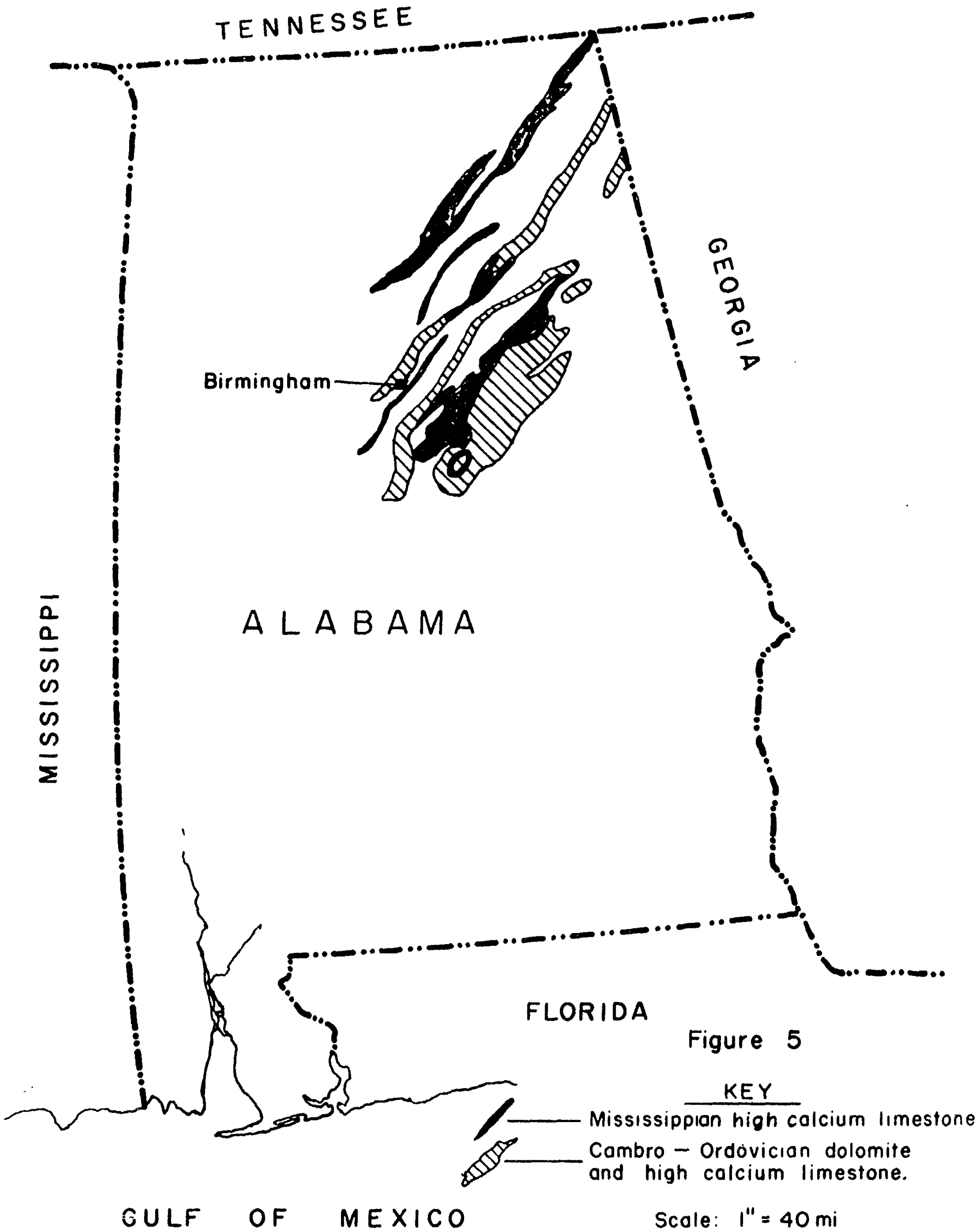
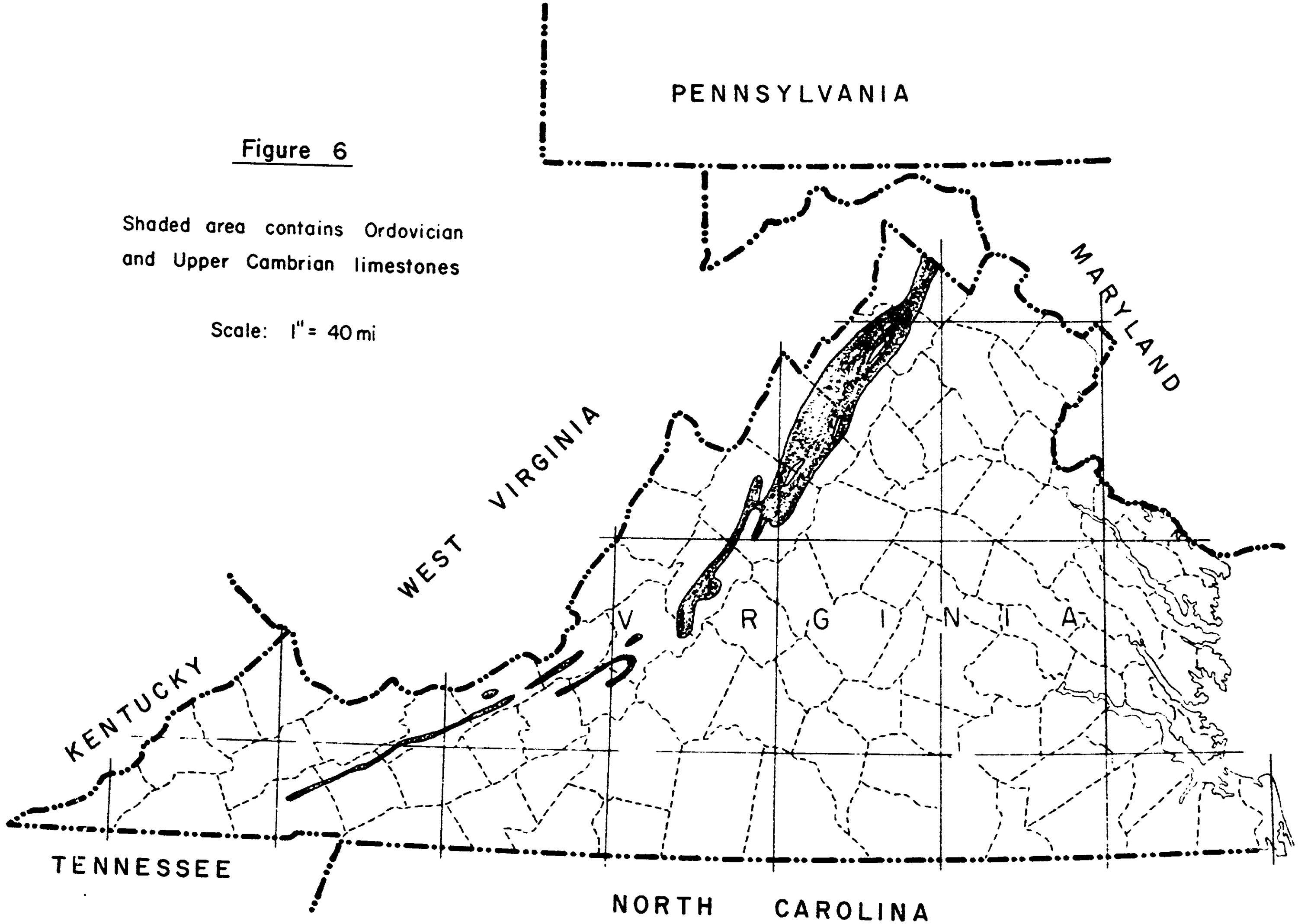

TENNESSEE
GEORGIA
MISSISSIPPI
Birmingham
ALABAMA
FLORIDA
GULF OF MEXICO
KEY
Mississippian high calcium limestone
Cambro — Ordovician dolomite and high calcium limestone.
Scale: 1" = 40 mi

Figure 5

Figure 6

Shaded area contains Ordovician and Upper Cambrian limestones

Scale: 1" = 40 mi



Because of the pockety nature of the infolded early Paleozoic limestones of Virginia the quarriable reserves of the individual deposits are quite limited. Furthermore, the Virginia stone lessens in place value to the southwest of the West Virginia panhandle because of increasing distance to steel centers in the northeastern United States, and to tide water.

References: William Randall Brown, "Geology and Mineral Resources of the Lynchburg Quadrangle, Virginia", Virginia Division of Mineral Resources, Bulletin 74, 1958, 99 pp.; Raymond S. Edmundson, "Industrial Limestones and Dolomites in Virginia, James River District West of the Blue Ridge", Virginia Division of Mineral Resources, Bulletin 73, 1958, 137 pp.; Byron N. Cooper, "Industrial Limestones and Dolomites in Virginia, Clinch Valley District", Virginia Geological Survey Bulletin 66, 1945, 259 pp.; R. S. Edmundson, "Industrial Limestones and Dolomites in Virginia, Northern and Central Parts of the Shenandoah Valley", Virginia Geological Survey, Bulletin 65, 1945, 194 pp.; Byron N. Cooper, "Industrial Limestones and Dolomites in Virginia, New River-Roanoke River District", Virginia Geological Survey, Bulletin 62, 1944, 98 pp.

Illinois

Illinois is the first state in the annual production of crushed limestone. Most of this stone is used in concrete aggregate and for road metal, in which Illinois is the leading producer. It ranks seventh in the production of fluxstone, and is also a large producer of lime. Although several formations are worked in Illinois for metallurgical stone the leading areas are in Silurian (Niagaran), Mississippian, and Ordovician rocks (Figure 7).

Niagaran dolomite. Illinois has considerable production of dolomite of B-1 grade quarried from the Niagaran dolomite outcrop zone of northeastern Illinois (including Cook County). Some quarry sections here are unusually thick and fairly pure, but this situation is not true throughout the outcrop belt. Dolomite is extensively quarried in Chicago and vicinity for use in lime burning and for fluxstone, as well as for other volumetrically much more important uses. Although there is a considerable quantity of Niagaran dolomite of good quality not yet quarried in the Chicago district, most of it is not available because of high land costs, zoning laws, and highway construction. Many of the quarries are completely surrounded by built-up areas. The quality of the Niagaran stone becomes poorer to the south, and at Kankakee in Kankakee County the dolomite runs from three to ten percent silica.

Mississippian limestones. A belt of middle Mississippian limestones crops out in the bluffs of the Mississippi River both upstream and downstream from the Alton-East St. Louis industrial area. Included are the Salem, St. Louis, and Sainte Genevieve limestones. They are mined and quarried for many purposes, including lime burning, fluxstone, and chemical manufacture. The stone is high calcium limestone and is mostly of A-2 quality, but some of the ledges qualify for A-1 classification. Occurring as it does in the St. Louis metropolitan area, this stone is high in place value.

The same series of limestones also crosses the southern tip of Illinois from the Mississippi River to the Ohio River.

The next oldest Mississippian limestone, the Burlington, is not shown on the map because it rarely qualifies for metallurgical or chemical uses. It is, however, an important source of lime in the Quincy area where it is both mined and quarried. In some quarries the upper part of the Burlington may run as much as 50% chert.

Kimmswick limestone. This much older limestone of Ordovician age occurs in patches along the Mississippi River between Quincy and Alton, below East St. Louis, and north of Cairo (Figure 7). It has been mined in a deposit below East St. Louis as a source of lime. A part at least of this stone is of A-1 quality.

References: J. E. Lamar, "Illinois", in Chapter 8 "The Carbonate Rocks", American Institute of Mining, Metallurgical, and Petroleum Engineers, Industrial Minerals and Rocks, 1960, pp. 168-170; James W. Baxter, "Salem Limestone in Southwestern Illinois", Illinois State Geological Survey, Circular 284, 1960, 32 pp.; J. E. Lamar, "Limestone Resources of Extreme Southern Illinois", Illinois State Geological Survey, Report of Investigations 211, 1959, 81 pp.; H. B. Willman, "High Purity Dolomite in Illinois", Illinois State Geological Survey, Report Investigations 90, 1943, 89 pp.; J. E. Lamar and H. B. Willman, "High Calcium Limestone Near Morris, Illinois", Illinois State Geological Survey, Report of Investigations 23, 1931, 26 pp.; J. E. Lamar, "Limestone Resources of the Pontiac-Fairbury Region", Illinois State Geological Survey, Report of Investigations 17, 1929, 27 pp.; Frank Krey and J. E. Lamar, "Limestone Resources of Illinois", Illinois Geological Survey, Bulletin 46, 1925, 392 pp.

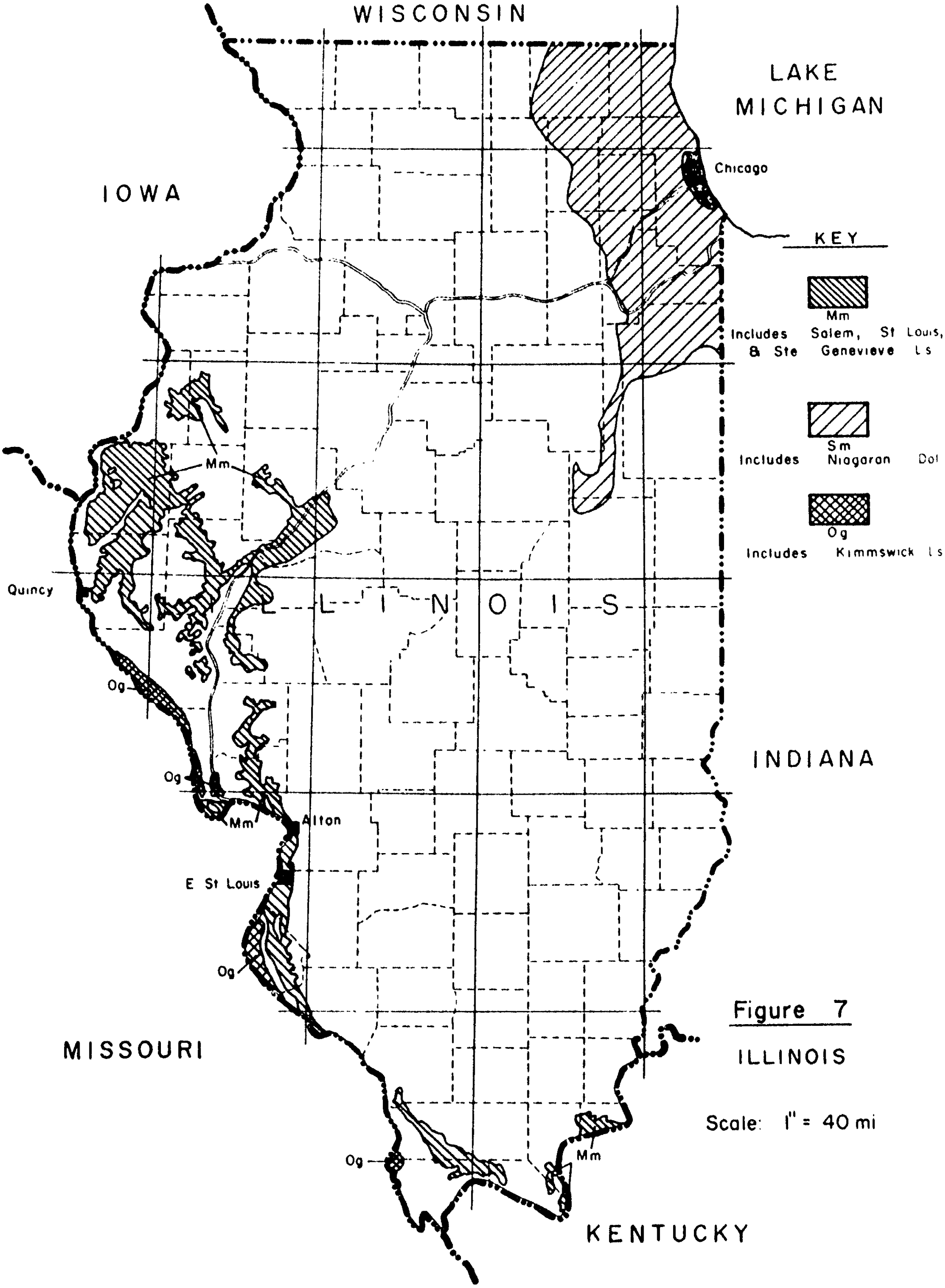


Figure 7

ILLINOIS

Other States

There are, or course, other states containing high calcium limestone and dolomite of metallurgical grade, and there is some production from those states of limestone for fluxing and chemical purposes. These states produce relatively small quantities of such stone for one of three reasons (1) the deposits are small and the reserves inadequate for large scale production; (2) the stone does not meet usual flux and chemical stone specifications, but is exploited locally because of abnormally high place value of the deposit; or (3) the deposits are remote from metallurgical or chemical markets so is low in place value and has a very limited market for furnace or chemical use.

Massachusetts. Massachusetts dropped from fourth place in lime production in 1932 to sixteenth place in 1961, probably due to the working out of the higher grade stone deposits. All of the commercial limestone deposits in this state are in Berkshire County in western Massachusetts. The calcareous formations are Cambrian and Ordovician in age. Some A-1 limestones are present and some of the dolomites and dolomitic limestones are of B-1 grade. The higher quality stone is burned for lime, and a few thousand tons are marketed each year for flux.

Reference: T. Nelson Dale, "The Lime Belt of Massachusetts", U. S. Geological Survey, Bulletin 744, 1923, 71 pp.

New York. Although New York ranks eighth among the states in crushed limestone production, its annual output of fluxstone and lime rock is relatively insignificant. Most of New York's limestone is below A-2 or B-2 in grade and is used in concrete aggregate, road metal, and railroad ballast. The metallurgical stone resources are largely confined to Precambrian dolomite and Silurian limestone.

Some of the Grenville dolomite (Precambrian) which occurs in St. Lawrence and Jefferson Counties in northern New York is B-1 in grade. It has been quarried near Natural Bridge, Jefferson County, and dead-burned for use as a refractory. Likewise some of the Precambrian dolomites in Westchester and Dutchess Counties north of New York City are B-1 in grade and have been exploited for lime manufacture. These occurrences are, however, local in character and because of the variable silica content of the Precambrian carbonate formations it is very unlikely that large deposits of B-1 grade stone are to be found in the New York-New England province.

From the available analyses there appears to be little or no A-1 Silurian stone in New York in quarriable volumes. The Clinton limestone becomes fairly pure in the western part of the state and is there of A-2 grade. It has been extensively quarried in the vicinities of LeRoy and Stafford, Genesee County, and Lockport and Gasport, Niagara County, for use as flux in the blast furnaces of the Buffalo district. Waterborne A-1 grade stone from Michigan and rail-borne high calcium limestone from Ontario have replaced local fluxstone in this district in recent years.

Devonian limestone has been exploited for many years near Syracuse for the manufacture of soda ash and other chemicals.

References: F. M. Swain, "Limestone and Dolomite Along the Pennsylvania Railroad System in New York", Pennsylvania State College, School of Mineral Industries Experiment Station, Dec. 1944 , 13 pp.; David H. Newland, "The Mineral Resources of the State of New York, Bulletin N. Y. State Museum, Nos. 223, 224, pp. 255-268, 1921.

Maryland. Maryland is unimportant as a source of metallurgical stone, but does produce a little lime. The same Ordovician formations which contain the better quarry ledges in southeastern Pennsylvania to the north and in the "pan-handle" of West Virginia and in northwestern Virginia to the south cross western Maryland at almost its narrowest part, passing through Frederick and Washington counties. A-2 stone is quarried and burned for lime at several communities in the former county, and at Cavetown in Washington County. These infolded limestone bodies are lenticular and decidedly limited in volume.

Reference: R. B. Neuman, "St. Paul Group, A Revision of the 'Stones River Group' of Maryland and Adjacent States", Geological Society of America, Volume 62, March 1951, pp. 267-324.

Indiana. Indiana, although the leading producer of limestone building stone, ranks tenth in crushed limestone and only an insignificant percentage of this material is used for metallurgical purposes. The reason for this is the virtual absence of metallurgical grade stone in quarriable deposits except the Salem limestone which is more valuable for building purposes. Niagaran rock, the outcrop of which extends into Indiana from the northwest, is not suitable for furnace use. The only limestones which are quarried in volume are the Sainte Genevieve, Salem, and other Mississippian formations. These are exploited in Washington and Harrison Counties in southern Indiana for roadstone.

To the northwest, in Lawrence and Monroe Counties, the Salem high calcium limestone is quarried in considerable volume for dimension stone; some lime is burned and a little furnace flux is sold as by-products of the building stone industry.

References: Duncan J. McGregor, "Indiana" in Chapter 8 "The Carbonate Rocks", American Institute of Mining, Metallurgical, and Petroleum Engineers, Industrial Minerals and Rocks, 1960, pp. 162-164; John B. Patton, "Crushed Stone in Indiana", Division of Geology, Indiana Department of Conservation, Report of Progress No. 3, April 1949, 47 pp.

Tennessee. Tennessee produces considerable crushed limestone, but most is below A-2 or B-2 in grade. Some stone is sufficiently pure, however, for lime burning. The lime rocks occur in both Cambro-Ordovician and Mississippian formations. Within the broad belt of Cambro-Ordovician formations crossing southeastern Tennessee are several limestones and dolomites which are locally of A-1 or B-1 grade. Some of the purest limestones in Tennessee are the upper Mississippian Gasper oolite and Sainte Genevieve limestone which occur in deposits up to 150 feet in thickness in the Highland Rim area.

References: R. G. Sterns, "Tennessee", in Chapter 8 "The Carbonate Rocks", American Institute of Mining, Metallurgical, and Petroleum Engineers, Industrial Minerals and Rocks, 1960, pp. 173-174; George I. Whitlach, "Limestone and Lime", Tennessee Geological Survey, Markets Circular No. 10, April 1941, 38 pp.

Wisconsin. Only minor amounts of limestone quarried in Wisconsin are used for lime and flux. By far the greater part of the production goes into concrete aggregate, road metal, and agricultural stone.

The only metallurgical stone quarried is the Niagaran dolomite which crops out in a broad band parallel to the Lake Michigan shore line from the Door Peninsula to northeastern Illinois. The largest lime production is in Manitowoc County. Lime is or has been burned in Sheboygan, Fond du Lac, Dodge, and Ozawkie counties. The Niagaran dolomite used for lime burning ranges in grade from B-1 to B-2. Scattered analyses show a silica content varying from .02% to 8.2%, with over half above 1%.

Reference: Edward Steidtmann, "Limestones and Marls of Wisconsin", Wisconsin Geological Survey, Bull. 66, 1924, 208 pp.

Iowa. Devonian limestones in eastern Iowa are quarried mainly for commercial stone, but a small percentage is sold as fluxing stone. The only lime plant in the state produces chemical and industrial lime from a Devonian limestone in Scott County.

Reference: H. Garland Hershey, "Iowa", in Chapter 8 "The Carbonate Rocks", American Institute of Mining, Metallurgical, and Petroleum Engineers, Industrial Minerals and Rocks, 1960, pp. 176-178.

Missouri. Missouri ranks third in the annual production of lime. The yearly output of fluxstone is negligible, but much of the lime is used for metallurgical purposes. Some of the lime is obtained from the Ordovician Kimmswick formation, but most is burned from limestones of Mississippian age.

The Trenton Kimmswick formation contains deposits of metallurgical grade limestone in eastern Missouri south of St. Louis. It is actively exploited for lime rock in Jefferson and Sainte Genevieve Counties.

Mississippian formations outcrop in a broad band fringing the Ozark uplands area and extending northward into northeastern Missouri and western Illinois. The Mississippian rocks are predominantly limestones, and some of the limestones contain deposits of metallurgical grade stone. Three centers of lime production have been established in the belt of Mississippian outcrop. The largest of these is in the vicinity of Sainte Genevieve in Sainte Genevieve County. Here the lime rock is the Spergen formation. To the west, in southwestern Missouri, is a second lime producing district. The largest plants are in Greene County in and near Springfield. The third district is in the vicinity of Hannibal in northeastern Missouri, where the Mississippian Burlington limestone is quarried and burned.

References: W. C. Hayes, W. V. Searight, and J. W. Koenig, "Missouri", in Chapter 8 "The Carbonate Rocks", American Institute of Mining, Metallurgical, and Petroleum Engineers, Industrial Minerals and Rocks, 1960, pp. 170-173; E. R. Buckley and H. A. Buehler, "The Quarrying Industry of Missouri", Missouri Bureau of Geology and Mines, 2nd series, Volume 2, 1904, 371 pp.

Texas. Texas has risen from a relatively small lime industry in 1946 to sixth place; in fluxing stone it has risen to ninth place. The state contains many limestones, but metallurgical grade stone is scarce.

The smelters of the El Paso district furnish a market for metallurgical lime and fluxstone obtained from Ordovician and Lower Cretaceous limestones which crop out in the immediate vicinity.

The principal lime rock in Texas is the Austin chalk formation (Cretaceous) which averages only 70 to 90 per cent calcium carbonate, but locally may have adequate purity for exploitation. This formation is quarried and burned for lime in several places in east central Texas, especially in Comal, Travis, and Williamson Counties. Chemical lime is produced south of San Antonio and shipped to the growing industrial area about Corpus Christi. Bedrock limestone has to compete with dredged oyster shell for the high quality stone market along the Gulf coast.

Colorado. About 20 per cent of Colorado's annual crushed limestone production is used as a flux in the Pueblo iron furnaces and in the smelters of Colorado's mineral belt. Most of the limestones in this state are too impure for metallurgical purposes, but two formations, occurring in the Mississippian and the upper Cretaceous, are locally adequate for fluxstone and lime burning.

The Leadville and other massive limestones of the Mississippian system are exploited in Colorado for metallurgical stone. Biggest production is at Monarch west of Salida in Chaffee County where fluxstone is quarried for use at Pueblo and Leadville. Another Mississippian limestone deposit at Rockwood north of Durango in La Plata County, southwestern Colorado, has been developed for both lime rock and flux.

The Timpas member of the Cretaceous Niobrara formation is exploited in east central Colorado, especially in Pueblo, El Paso and Fremont counties, for cement, lime, and flux.

Reference: John W. Vanderwilt, "Mineral Resources of Colorado", Colorado Mineral Resources Board, 1947, pp. 244-246.

Utah. Utah is the eighth state in fluxstone production, immediately following Illinois. About one-third of the crushed limestone produced in this state is used as a fluxing stone, not only in the copper smelters and steel plants within the state, but also in similar plants in California and in the El Paso, Texas, area. Limestones are scarce in the southwest so metallurgical grade stone here has high place value and can also travel unusual distances to market.

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Leading counties for metallurgical and lime burning stone are Tooele and Utah. In addition to fluxing stone, dolomite is also quarried for refractory uses.

California. California is the leading state in the production of portland cement. It is ninth in lime production. This state also produces refractory dolomite, chemical stone, and fluxing stone, but the quantities are small because there is very little metallurgical grade stone in California. For this reason, steel companies have gone as far away as Utah, British Columbia, and Alaska in seeking stone of the quality needed.

The California limestones, used mainly in the manufacture of portland cement and in lime burning, are mostly of Paleozoic age. They occur as inliers in the highly folded Mesozoic and Cenozoic sedimentary and volcanic rocks. The deposits are discontinuous and individual deposits have a relatively short life.

Limestone has been reported from 52 of the 58 counties of California. During 1961 nineteen lime plants were in operation in thirteen counties; four-fifths of the total production came from plants in northern California. Much of the lime produced is used in open hearth steel furnaces and by the chemical industry.

Although most of the limestone produced is high calcium stone, dolomite also is produced and is used as a refractory and for chemical purposes.

References: Earl W. Hart, "Geology of Limestone and Dolomite Deposits in the Southern Half of Standard Quadrangle, Tuolumne County, California", The California Division of Mines, Special Report 58, 1959, 25 pp.; Oliver E. Bowen, Jr. and Cliffton H. Gray, Jr., "Geology and Economic Possibilities of the Limestone and Dolomite Deposits of the Northern Gabilan Range, California", California Division of Mines, Special Report 56, 1959, 40 pp.; O. E. Bowen, Jr., "Mineral Commodities of California", California Division of Mines, Bulletin 176, 1957, pp. 113-120, 293-306; William B. Clark, "The Cool-Cave Valley Limestone Deposits, El Dorado and Placer Counties, California", California Journal of Mines and Geology, Volume 50, Nos. 3 and 4, July-October 1954, pp. 439-466; Oliver E. Bowen, Jr., "Geology and Mineral Deposits of Barstow Quadrangle, San Bernardino County, California", California Division of Mines, Bulletin 165, April 1954, pp. 160-170.

RESERVE PICTURE

It was determined during the preparation of the first edition of this study 15 years ago, by inquiries sent to members of the National Lime Association, that the average life expectancy of the metallurgical grade limestone deposits then being worked was less than 30 years, and that an average of $10,000 was being spent by each responding company each year in the search for new deposits. Since then many deposit life expectancies have been shortened by increases in quality specifications, or by condemnation of valuable stone land for highway (including interchanges) rights-of-way, or for other reasons.

Likewise the search for adequate undiscovered limestone deposits has become more and more difficult, and more and more expensive.

It can be assumed that most of the limestone of metallurgical grade that will be needed fifty years hence has not yet been discovered, and the finding of it will not be cheap.

The CHAIRMAN. The next witness will then be Mr. Paul W. Seitz, first vice chairman of the board, National Limestone Institute, Inc., accompanied by Richard Brady.

STATEMENT OF PAUL W. SEITZ, FIRST VICE CHAIRMAN OF THE BOARD; ACCOMPANIED BY RICHARD BRADY, COUNSEL, AND ROBERT KOCH, PRESIDENT, NATIONAL LIMESTONE INSTITUTE, INC.

Mr. SEITZ. Thank you.

Senator CURTIS. Mr. Chairman, could I ask a question. I would like to know to what extent there is an overlap in the organizations of the National Crushed Stone, the National Lime Association, and the National Limestone Institute. Is it true that all three of them are involved with some of the types of lime?

Mr. SEITZ. Yes; that is true.

The CHAIRMAN. Is there an overlap in these organizations or are they testifying to the same point or is there some difference of opinion between them?

Mr. SEITZ. The organizations are distinct organizations operating separately from one another.

The CHAIRMAN. I see.

Mr. SEITZ. I am Paul W. Seitz, first vice chairman of NLI's board of directors, and am appearing today on behalf of all members of the National Limestone Institute. I am also president of May Stone and Sand, Inc., of Fort Wayne, Ind. I am accompanied by Richard Brady of Covington & Burling, counsel to the National Limestone Institute, and on my left Robert Koch, president of the National Limestone Institute.

The institute's members appreciate this opportunity of presenting to the committee its views on section 501(a) of H.R. 13270.

The National Limestone Institute is an industry association composed of 549 limestone producers located in 34 States. Its members produce aggregates for highways and other construction, agricultural limestone, and other limestone products.

The National Limestone Institute opposes the proposed reductions under the House bill in the existing percentage depletion rates for limestone from 15 and 5 percent to 11 and 4 percent.

Percentage depletion recognizes that mineral resources are wasting assets, and it is an important part of the national minerals policy to assure an adequate supply of natural resources at a reasonable cost to the consuming public. The proposed rate reductions indicate a significant change in this policy, and should be carefully considered. They were not based upon any study of either the limestone industry or the mining industry generally. It is unlikely that the Ways and Means Committee even considered them in terms of any mining industry other than oil and gas.

I think I could best serve your time this morning by giving you some examples of what percentage depletion has meant to the limestone industry. Congress passed the Highway Act of 1956, the largest peacetime construction program in the history of our country—40,000 miles, costing $41 billion, later raised a 42,500 miles, costing $60 billion.

Our industry, together with others have supplied all aggregates required for the construction without any outside help. After the 1956 Highway Act was enacted, the Federal Bureau of Public Roads contacted the States, offering Federal aid in exploration and development of aggregate sources as the immensity of the program was thought too large for private industry.

When these people visited Indiana, and offered their views, we suggested our industry could provide the know-how and capital without outside help. To this day we have not faltered, nor has any faltering anywhere in the United States been brought to our attention.

Percentage depletion has offered us the opportunity to get the job done, and of course we do not stop here, for ahead is an ever greater demand for our industry, to supply the basic materials for progress.

Since our industry is a depletable natural resource, we are constantly exploring for new deposits, especially to meet ever more rigid specifications. We as an industry not only deplete our resources but in many instances are curtailed by zoning regulations where the aggregate is available, which can mean additional exploration and development. In order to obtain and hold this natural resource, many capital dollars are invested for many years ahead.

Senator GORE. Could I ask my question now?

You have made a statement: The percentage depletion allowance has absolutely no connection with depletion or with discovery. It is merely a formula for tax reduction. You would get it whether or not you made any discovery or whether or not you depleted your product.

Thank you, Mr. Chairman.

The CHAIRMAN. Do you want to reply to that?

Mr. SEITZ. No; I think not.

Senator GORE. Well, it is a factual statement.

Mr. SEITZ. Our industry is quite different in selecting a plant site as compared to a manufacturing industry which locates a plant by availability of manpower, transportation and consumer market; however, we go to the natural resource.

Even with these handicaps our industry has maintained a very favorable selling price, not escaping inherent higher costs which have been influenced by inflation, with an average selling price in 1967 of $1.38 for all limestone products compared with $1.40 in 1950.

We have kept pace with many technological advancements, and maintain a supply of limestone for the marketplace, even though we are a group of many small businesses working on small profits. Any change in percentage depletion, and the incentive it offers the mining industries, could materially affect our ability to keep pace as an independent enterprise. If we have proven our ability to supply an ever-expanding economy, we certainly have proven the value of private enterprise at work.

Nonetheless of importance is our role in the health of the Nation in supplying much needed calcium in the form of agricultural limestone.

The major direct role of limestone in national health is the influence of the calcium released from it to be absorbed by the exchange complex of soils taken up by plants and eventually by animals including man.

Today we supply agricultural limestone at an annual rate of 30 million tons, but college agronomists tell us that 80 million tons are needed on an annual basis just to maintain a calcium balanced soil.

We as an industry can do the job as we have been doing it if the incentive for private enterprise is allowed to progress without interference by changing the encouragement offered by percentage depletion.

Thank you.

The CHAIRMAN. Thank you very much.

The next witness will be——

Senator MILLER. Mr. Chairman, I have four questions.

The CHAIRMAN. The four questions being submitted, will you please provide the answers to Senator Miller?

Mr. SEITZ. Yes, sir.

The CHAIRMAN. Thank you, Mr. Seitz.

(Mr. Seitz' prepared statement and answers to questions of Senator Miller, follow:)

COVINGTON & BURLING,
Washington, D.C., September 30, 1969.

Senator JACK MILLER,
Committee on Finance, U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR SENATOR MILLER: Paul W. Seitz, witness for the National Limestone Institute, Inc. has asked me to deliver to you the following answers to the questions you asked Mr. Seitz at this morning's hearings. Mr. Seitz and National Limestone Institute regret that the information to answer your questions more precisely is not available.

If you or other members of the Committee have any further questions, Mr. Seitz and the National Limestone Institute will be pleased to do whatever they can to respond.

Q. What are estimated total gross sales of your Association of agricultural limestone?

A. National Limestone Institute does not accumulate statistics on sales of agricultural limestone by its members. It believes, however, that its members are responsible for a significant portion of the total production of agricultural limestone in the United States. The total production of agricultural limestone (including small quantities of dolomite) for 1967 has been reported by the Department of the Interior in the Minerals Yearbook as 29,245,000 short tons valued at $51,463,000.

Q. What is the total annual percentage depletion allowance (for tax purposes) for agricultural limestone?

A. The Treasury Department has never included in its published statistics the aggregate percentage depletion deduction claimed with respect to agricultural limestone, and the general statistics it does make available to the public offer no basis on which to compute the amount of this deduction. Since in any given year some agricultural limestone operations will result in a loss or a small profit, some production of agricultural limestone will have either no percentage depletion deduction or a deduction measured by the 50 percent of taxable income limitation. These factors make it impossible to compute the percentage depletion deduction for agricultural limestone on the basis of production statistics.

Q. Please relate the foregoing to any estimates you wish to submit of additional costs to the agriculture industry if the rate of percentage depletion is reduced for agricultural limestone as provided in the House bill.

A. The impact of the proposed cutback on the agriculture industry is uncertain. First, the amount of additional taxes to be paid by producers of agricultural limestone is not known. Second, there is no clear indication of how agricultural limestone producers will respond to their additional tax burden. Some will likely attempt to raise their prices to transfer the burden of their additional taxes to the agriculture industry.

Q. What is the estimated annual expenditure by your Association for exploration, research and development, including construction of mining facilities?

A. National Limestone Institute has no information on which to base such an estimate. Neither the Bureau of Mines nor any private studies have attempted to develop the necessary information. The diversity of operations that exist among producers within the limestone industry makes impractical any estimate not based on an actual survey.

Very truly yours,

RICHARD A. BRADY,
Counsel for National Limestone Institute, Inc.

STATEMENT OF NATIONAL LIMESTONE INSTITUTE, INC., PRESENTED BY PAUL W. SEITZ, FIRST VICE CHAIRMAN OF THE BOARD OF DIRECTORS

SUMMARY

(1) The National Limestone Institute, Inc. is an industry association composed of some 549 limestone producers located in 34 states. Its members produce aggregates for highways and other construction, agricultural limestone, and other limestone products.

(2) The National Limestone Institute opposes the proposed reductions under the House bill in the existing percentage depletion rates for limestone from 15 and 5 percent to 11 and 4 percent.

(3) Percentage depletion recognizes that mineral resources are wasting assets and is an important part of the National minerals policy to assure an adequate supply of natural resources at a reasonable cost to the consuming public. The proposed rate reductions indicate a significant change in this policy and should be carefully considered. They were not based upon any study of either the limestone industry or the mining industries generally, and it is unlikely that the Ways and Means Committee even considered them in terms of any mining industries other than oil and gas.

(4) The economic impact of the proposed rate reductions would be severe in the case of individual producers in the limestone industry. It is an industry of small businesses and modest profit margins. The average price of limestone has actually decreased from $1.40 per ton to $1.38 per ton since 1950, when limestone was granted percentage depletion, although the producers' costs have increased substantially during the same period.

(5) Investors in the limestone industry need the incentive of percentage depletion to develop limestone deposits and produce marketable limestone products efficiently in order to meet the demand for limestone which has almost tripled since 1950 and which is expected to continue to grow parallel to the trends in population and gross national product.

STATEMENT

I am Paul W. Seitz, First Vice-Chairman of NLI's Board of Directors, and am submitting this statement on behalf of all members of the National Limestone Institute. I am also President of May Stone and Sand, Inc., of Fort Wayne, Indiana. National Limestone Institute's members appreciate this opportunity of presenting to the Committee its views on Section 501(a) of H.R. 13270.

The National Limestone Institute, Inc. is an industry association composed of some 549 limestone producers located in 34 states. Its members produce aggregates for highways and other construction, agricultural limestone, and other limestone products.

Limestone is presently entitled to a 15 percent depletion rate unless it is used, or sold for use, or riprap, ballast, road material, rubble, concrete aggregates or for familiar purposes. The rate for limestone used for these purposes is 5 percent.[1] Under the House bill, the allowable rates would be cut from 15 and 5 percent to 11 and 4 percent.

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[1] Under the 1939 Code only metallurgical grade and chemical grade limestone were entitled to 15 percent. During those years substantial controversy developed over the classification of a limestone deposit, and several litigated cases failed to develop a satisfactory distinction between metallurgical and chemical grade and other limestone. The matter was resolved in the 1954 Code by elimination of the metallurgical and chemical grade classification and introduction of the end-use test under which limestone used for aggregates, etc. is entitled to only 5 percent. The present statutory rule is a rational classification, and National Limestone Institute believes that a classification based on metallurgical and chemical grade is not sound.

The National Limestone Institute opposes the proposed reductions in the existing percentage depletion rates.

Percentage depletion was made available to limestone in 1951 as part of the National minerals policy to provide an adequate supply of all minerals to satisfy the demands of an expanding economy and the requirements of security and to assure an orderly development of the Nation's natural mineral resources. Percentage depletion is a fundamental part of this National policy. It recognizes that mineral resources are wasting assets and that new reserves must be found and developed.

During the years percentage depletion has been available, the limestone industry has participated in the Nation's economic growth. According to statistics published by the Bureau of Mines, production has almost tripled.[2] All segments of the

Short tons	180,918,910
Value	$252,755,827
1967 (including small quantities of dolomite):	
Short tons	508,902,000
Value	$783,135,000

limestone industry have contributed to this growth. As is the case with the mining industry generally, the impact of limestone's growth has been felt directly in construction, agriculture and the many other industries using limestone products, and indirectly throughout the economy.[3]

Any change in National policy that would adversely affect the growth of the mining industries should be carefully considered. The symbolism of tax reform and revenue gains should not be allowed to change this country's successful minerals policy. The proposed percentage depletion rate reductions would change this policy, however, even though the decisions of the Ways and Means Committee were not based upon any study of either the limestone industry or the mining industries generally. It is unlikely that the Committee even considered the proposed rate reductions in terms of any mining industries other than oil and gas. The mining industries should not be the unfair victims of tax reform.

The economic posture of the limestone industry should be understood in order to evaluate the impact of the proposed percentage depletion rate reductions. Although the volume of limestone production has grown impressively, the industry continues to be primarily small businesses. As the Bureau of Mines' statistics cited above indicate, the average selling price of limestone since 1950, a period of National growth—and generally rising prices—has actually decreased from $1.40 per ton in 1950 to $1.38 per ton in 1967. On the other hand, the industry has not escaped cost increases prevailing in the Nation's economy. Air and water pollution control, noise control, and compliance with land zoning requirements have been additional factors in increasing costs. The consequence has been that the industry has spent large sums to develop limestone deposits and produce marketable limestone products *efficiently* in order to be competitive with other minerals, especially those also suitable for use as aggregates.[4] Nevertheless, profit margins have been narrow.

Although the aggregate percentage depletion deduction for limestone is not available, it is very doubtful that the proposed rate reduction will yield a meaningful increase in revenues. The impact on individual producers, however, will be significant. As in the case in the mining industries generally, percentage depletion has become an integral part of the economics of the limestone industry, and maintenance of the existing percentage depletion rates is necessary to avoid serious dislocations. These rates are not generous—15 percent is the rate for minerals generally and 5 percent is the minimum rate. Cutbacks from these levels in an industry of small businesses and modest profits will have adverse consequences, including possible price increases and reduced expenditures to find and obtain new deposits and to modernize operating methods.

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[2] 1950:

[3] Hearings on Mineral Shortages Before the Subcommittee on Minerals, Materials, and Fuels of the Senate Committee on Interior and Insular Affairs, 90th Cong., 2d Sess., 32 (1968).

[4] Modernization is discussed, for example, at pp. 1067–68 of Minerals Yearbook, 1967 of the Department of Interior.

It is inevitable that the economic dislocation of the House proposal will affect the capital values the risk element of limestone producers with adverse effects on supply. The impact on the Nation would be significant. The Bureau of Mines has projected massive increases in the demand for limestone during the remainder of this century. Its growth will closely parallel trends in population and gross national product. Although reserves of limestone are substantial, they are being depleted at a high rate. The Bureau of Mines has reported [5] that "exacting specifications determine the marketability of stone in important instances and sources adequate for such needs at reasonable costs are not unlimited," and further that "because of the variety of industrial uses the local availability of stone that will meet specifications of local markets influences the industrial and economic development potential of an area."

The CHAIRMAN. The next witness is Mr. Rhyne Simpson, Jr., first vice president of the Gypsum Association.

STATEMENT OF RHYNE SIMPSON, JR., FIRST VICE PRESIDENT OF THE GYPSUM ASSOCIATION

Mr. SIMPSON. Good morning, Mr. Chairman.

Good morning, members of the committee. My name is Rhyne Simpson, Jr. I am president of Republic Gypsum Co. and first vice president of the Gypsum Association. We mine gypsum and manufacture gypsum wallboard. We are one of the 13 companies in the United States who mine and then process gypsum into a building material product called gypsum wallboard.

The Gypsum Associattion represents over 90 percent of the mining capacity and the gypsum wallboard manufacturing capacity in the industry. I am speaking on behalf of the Gypsum Association members in opposing a reduction in the depletion allowance on gypsum from 15 percent to 11 percent.

You have a copy of my formal statement. I will not go over it in detail.

The CHAIRMAN. It is in the record.

Mr. SIMPSON. But I would like to make a few points about how the reduction in the depletion allowance will affect our company.

As I mentioned, we mine gypsum and manufacture gypsum wallboard. Gypsum wallboard is a prefabricated building material used primarily in the construction of residential shelter. Our company is also active in the manufacture of housing.

Gypsum is mined by various ways in the United States, both underground mines and strip mines.

Our industry is unique in that 75 percent, over 75 percent of the gypsum mined is used in some form or another in residential house construction.

In this last year our industry has been very hard hit by the very restrictive monetary policies of the Federal Government to control inflation. In spite of the fact that there has been a very significant increase in the demand for shelter, both demographic and social, we have seen a decrease in residential house construction in the last year.

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[5] These facts and many other important considerations are discussed in Hearings on Mineral Shortages before the Subcommittee on Minerals, Materials, and Fuels of the Senate Committee on Interior and Insular Affairs, 90th Cong., 2d Sess., 77 (1968), and at pp. 884–893 of Mineral Facts and Problems, 1965 Edition, a publication of the Department of Interior.

At the same time it is the policy of our National Government to increase residential house construction. It is our position that under the precedents set by retaining accelerated depreciation on residential house construction, we ask that gypsum be excluded from a drop in depletion from 15 percent to 11 percent.

We ask that it be added to those other minerals excluded from the drop. We feel that a continuation of the gypsum depletion allowance at 15 percent will help hold the price line on the cost of residential shelter to the consumer. At the same time, however, I should point out that gypsum products have not experienced an inflationary spiral like other building products. Just the contrary. In our prime marketing area in the Southwest, Texas, Oklahoma, and the States surrounding, gypsum wallboard today is sold at prices cheaper than during the depression years.

At the same time that the Federal Government is holding the line through monetary pressures on the economy, the building material industry has been asked to participate in ways to help increase the production of low-cost shelter. Operation Breakthrough is one of these ways.

Our company participated in Operation Breakthrough. As a matter of fact, we made our proposal September 19th to the Department of Housing and Urban Development. It might be interesting to you to know that the cost in just preparing this breakthrough proposal was greater than our entire depletion allowance last year.

Senator GORE. Is there any connection between the two?

Mr. SIMPSON. There is no connection between the two except for the fact that 75 percent of the rock that we mine does go into residential shelter.

Senator GORE. Why mention it then? There is no connection between depletion and anything except tax reduction.

Mr. SIMPSON. That is correct. That is our point, sir.

Senator GORE. Good.

Senator BENNETT. I would like to discuss that with my colleague at some other time, having invested in a mine that ran out before the depletion allowance was recovered.

Senator GORE. But it would not have affected percentage depletion if it had run out, or if it had not, if you had discovered further, or if you had not.

Mr. SIMPSON. Senator Gore, I did not mention the discovery of new gypsum reserves. As a matter of fact, I think it should be referred to quite frankly as a tax advantage, and that is what accelerated depreciation is, and I feel that for the same reason it should be applicable to our industry.

Senator GORE. Mr. Chairman, I have heard so much of this business: the relation between discovery and depletion of resources and in this booklet he has prepared, the relation of these to percentage depletion allowance, that I just wanted to make the record clear: there is no requirement that the amounts permitted a taxpayer in percentage depletion be set aside for discovery, there is no connection whatsoever between depletion of the resource, discovery of the new, and the setting aside of the reserve. As a matter of fact, I happen to know of an instance in which a mineral corporation had developed a reserve of several million dollars from percentage depletion. Control of the corporation was bought by another corporation, and it was promptly milked out and not $1 of it used for further discovery.

The CHAIRMAN. I would think if the Senator ever had my experience being the private possessor of a dry hole he would understand what it is all about better than he does.

Senator GORE. I have discovered a few sulfur wells trying to find water. I understand that. But that still has nothing to do with whether or not percentage depletion relates to finding a successful hole or finding a dry hole.

The CHAIRMAN. Let me see if I get the connection here.

Senator GORE. There is no connection.

The CHAIRMAN. Well, the witness said something. I am entitled to know what he said.

Senator GORE. He has a booklet there in which he referred to and talked about percentage depletion.

The CHAIRMAN. Let me see if I understand what the witness said. Would you mind explaining what is that booklet that you have there?

Mr. SIMPSON. Mr. Chairman, this booklet represents our proposal on Operation Breakthrough, which is a proposal of the Department of Housing and Urban Development to help foster and create new ways of building low-cost houses. In addition to mining gypsum we manufacture factory-built houses, another part of our business.

The CHAIRMAN. So as I understand it, you worked out at the expense of your company a proposal to produce housing cheaper for people?

Mr. SIMPSON. That is right. We have a large investment tied up in our management time, overhead, hard dollars invested in prototype units on this proposal. Now, there is no relation whatsoever between this and depletion, but I only wanted to relate that those are about the same dollars that we saved last year on taxes because of depletion.

What I did not say, was that we spent about four times that many dollars on looking for new gypsum reserves. While our industry is unique at this time because of the national policy to increase residential construction, the depletion allowance is important and necessary to help explore for new reserves.

Senator GORE. In other words, you say on the one hand that there is no relation but you say on the other that you want to relate?

Mr. SIMPSON. Yes, sir, I say exactly that. I want to relate it.

Senator GORE. Thank you. That is about how clear the relation is.

Mr. SIMPSON. Yes, sir. I want to relate it the same way that accelerated depreciation is being used as a tax shield to help foster increased residential housing.

The CHAIRMAN. As I understand it you are saying you save some money against taxes and what you save you put into lower cost houses to be built?

Mr. SIMPSON. Yes, sir.

The CHAIRMAN. That is the connection?

Mr. SIMPSON. Yes, sir.

The CHAIRMAN. What you save is spent trying to find a cheaper way to build somebody homes?

Mr. SIMPSON. Yes.

Senator MILLER. Yes, but in addition to that what you are saying is that the amount of the allowance for percentage depletion for your industry is more than spent for exploration and development?

Mr. SIMPSON. That is correct, for our company by a factor of 4 this last year.

Senator GORE. But you could have used the percentage depletion tax break you got for bigger dividends or for a new resort, a new motorboat, a new booklet. Or you can simply put it in reserves. I know of nothing that better illustrates the utter fallacy of the percentage depletion allowance as a tax principle. We ought to abolish it completely and put everyone on a cost depletion basis.

The CHAIRMAN. As I understand it, what you said here was that you spent four times as much money as you had in depletion allowance trying to find more gypsum somewhere?

Mr. SIMPSON. That is correct, and let me make another point. Our industry and the entire building material is changing, changing a great deal. You are seeing companies that have traditionally been active in nothing but gypsum wallboard leading the front on urban development in the United States. Our company a year ago was 90 percent active in gypsum wallboard, now only 35 percent active in gypsum wallboard, and over 50 percent of our sales come in house construction, so there is not a tie, but at the same time there is, because of an evolutionary process in American business.

The CHAIRMAN. Since we have digressed in this the latest figure I saw indicated that in this country on exploration for new oil, only one wildcat well in 43 was actually a good commercial producer.

That is not counting marginal wells. The point is—and I do not expect my good friend from Tennessee to agree with it, but the point is that just letting a man recover his money will not quite be enough incentive when the odds are 43 to 1 against you.

Mr. SIMPSON. That is correct.

The CHAIRMAN. You need something more than that.

Mr. SIMPSON. Yes, sir.

Senator GORE. Mr. Chairman, I will put in the record some very interesting figures on exploration; but since we have diverted to this I would like also to point out that there is a current writeoff of such exploration expenses. So they get it in two ways.

The CHAIRMAN. I made reference to that. The point is that if the odds are 43 to 1 against you, just getting your money back will not quite make it. That is the point.

Senator GORE. Mr. Chairman, the record shows that the odds are not of that proportion. They might be for one particular wildcat operation.

Senator BENNETT. I call for the regular order.

The CHAIRMAN. The regular order has been called for and I will call myself to order. Let the witness proceed.

Mr. SIMPSON. Let me summarize very briefly. W feel that our industry has suffered because of restrictive monetary policy. We feel that there has been a precedent set by including and retaining accelerated depreciation on residential shelter. We think by the same reasoning that gypsum should be left at 15 percent depletion rather than dropped to 11 percent. We, therefore, respectfully request that it stay at that level. I will be happy to answer any questions, and I do thank you for the opportunity to appear.

Senator MILLER. What is the annual total gross sales by your association?

Mr. SIMPSON. Although gross sales of the Gypsum Association total gypsum sales are not published. My personal estimate is approximately $350 million.

Senator MILLER. What is total annual depletion allowance—for tax purposes—of your association?

Mr. SIMPSON. The total annual depletion allowance is approximately $1,700,000, giving a tax savings of about $825,000.

Senator MILLER. Please relate the foregoing to any estimate you wish to submit of increased costs to consumers (by category, if possible—for example, homebuilders) resulting from reduction of percentage depletion rate from 15 to 11 percent for gypsum as provided in the House-passed "tax reform" bill.

Mr. SIMPSON. If the reduction of gypsum depletion from 15 to 11 percent is passed on to gypsum purchasers, shelter costs will increase by at least the amount of the total industry depletion allowance. Also, the loss of revenue to the industry will limit its participation in urban redevelopment products, and research and development in low-cost housing. This investment will ultimately reduce the cost of housing to all consumers. Thus, the effect is compounded by restricting research funds at a crucial time in the shelter industries development.

Senator MILLER. Thank you.

The CHAIRMAN. Thank you very much.

(Rhyne Simpson's prepared statement follows:)

STATEMENT OF GYPSUM ASSOCIATION PRESENTED BY RHYNE SIMPSON, JR., FIRST VICE PRESIDENT

PRELIMINARY STATEMENT

The Gypsum Association on behalf of its members oppose any reduction in percentage depletion rates. In the alternative, the Association requests relief for gypsum from the general 30% reduction in percentage depletion rates which had been proposed. Others have capably presented the argument against reducing depletion allowance for any industry. To avoid repetition we simply state our concurrence and deal here with the alternative should the Congress not see fit to maintain depletion allowances at their present level.

The gypsum mining industry, more than any other, is a part of the construction industry. It is substantially devoted to housing. How to increase construction of single and multi-family housing units is currently one of the country's most pressing problems. The need is obvious but the obstacles are almost insurmountable. Rising costs, labor problems, high interest rates and lack of funds, particularly in urban areas which have been greatly restricted by the tight money policies used to combat inflation, are paramount.

The gypsum industry is particularly hard hit because of its major dependence on construction. It respectfully requests that it not be further penalized, that it be exempt from any reduction which is voted, and allowed to retain its 15% depletion rate. Adequate precedent exists in the policy which already suggests exemption of iron and copper and which proposes to allow for residential construction the continued use of accelerated depreciation.

DISCUSSION

The Gypsum Association consists of 10 companies which operate over 75 gypsum mines and plants. The companies are:

The Celotex Corporation.
The Flintkote Company.
Georgia-Pacific Corporation, Gypsum Division.

GAF Corporation.
Grand Rapids Gypsum Company.
Kaiser Gypsum Company, Inc.
National Gypsum Company.
Republic Gypsum Company.
Texas Gypsum Company.
United States Gypsum Company.

The gypsum industry mined approximately 10,000,000 tons of gypsum domestically in 1968 based on preliminary Bureau of Mines figures.

The mineral gypsum in the ground is a rock, usually gray in color, which chemically is the dihydrate of calcium sulphate ($CaSO_4.2H_2O$). It is closely related to anhydrate which is calcium sulphate without the water of crystallization ($CaSO_4$). Gypsum has many uses, but its principal use is in the production and manufacture of low cost items, including retarder rock, plaster, lath and wallboard used by the construction industry, mainly in residential housing.

"Retarder" rock is sized crude gypsum used by Portland cement manufacturers as an additive to control the setting time of cement. This use accounted for approximately 3,154,000 tons of gypsum consumed in 1967 (the last year for which figures are available) having a total value of $14,704,000. The principal use of gypsum, however, is to manufacture products primarily used in residential housing (plaster, lath and wallboard). These are products made from calcined gypsum.

When raw gypsum rock is "calcined" or heated to approximately 320° F. literally three quarters of the water of crystallization ($2H_2O$) is boiled off. The resulting dry powdery product is known as stucco or plaster of paris, and is the basic ingredient for wall plaster, lath and wallboard.

Plaster is created by re-adding water to the stucco at the job site and spreading the resulting plastic mass on the desired surfaces where on drying it returns to its original rock state.

Gypsum lath and wallboard consist of materials such as paper or wood sandwiched around a core of reconstituted gypsum. In other words, stucco with the water added back. They are produced at the various gypsum plants located throughout the country.

These calcined products accounted for approximately 9,000,000 tons of gypsum during 1967 with a total value of approximately $342,000,000 over 90% of which was used in building and residential housing.

The calcined products are in great demand in housing as they provide relatively inexpensive walls with great fireproofing qualities. The price of standard ½" gypsum wallboard is approximately the same as it was in 1959 (Bureau of Mines figures). This undoubtedly is a unique record with today's inflation. Gypsum's fireproofing qualities result from the fact that a temperature of 250° F. releases gypsum's water of crystallization which absorbs heat and in effect puts out fire with water at its source.

The gypsum industry is an integrated mining-manufacturing industry. With minor exceptions, domestic gypsum is mined by the same company which manufactures it into plaster, lath and wallboard. This is due to the fact that it has been proven more economical to locate the plants for producing the calcined products at the mining locations. During the year 1967, there were gypsum mines or plants located in 33 states employing over 21,000 people, as follows:

CRUDE GYPSUM MINED IN THE UNITED STATES, BY STATES

[Thousand short tons and thousand dollars]

State	Active mines	1967 quantity	Value
Arizona	(1)	(1)	(1)
California	9	1,241	$3,150
Colorado	4	77	265
Iowa	5	1,219	5,186
Michigan	5	1,422	5,085
Nevada	3	409	1,412
New Mexico	5	155	588
New York	5	570	3,118
Oklahoma	8	804	2,266
South Dakota	1	12	49
Texas	7	984	3,419
Other States	23	2,500	9,845
Total	75	9,393	34,383

1 Withheld to protect confidential information.

CALCINED GYPSUM PRODUCED IN THE UNITED STATES, BY STATES

[Thousand short tons and thousand dollars]

State	Active plants	1967 quantity	Value	Calcining equipment: Kettles	Calcining equipment: Other
California	7	584	$7,641	16	9
Georgia	3	464	8,832	15	
Iowa	5	768	11,477	22	4
Louisiana	(1)	(1)	(1)	(1)	(1)
Michigan	4	362	5,929	10	1
New Jersey	4	347	4,056	9	4
New York	7	836	12,265	22	5
Ohio	3	334	4,960	9	1
Texas	7	723	10,519	27	3
Other States	36	3,461	49,788	94	50
Total	76	7,879	115,467	224	77

[1] Withheld to protect confidential information.

Because it produces products for the construction industry, and particularly for residential construction, the gypsum industry has been uniquely hard hit by the government's anti-inflationary policies. The Federal Reserve Board, commencing in 1966, embraced an anti-inflationary policy which was primarily directed to allocating resources by increasing borrowing costs. Thus, prime interest rates have increased from 4.5% to 8.5% since 1965, or an increase of approximately 9%. This has had a direct effect on the housing market. In 1965, housing starts were 1,510,000. These shrunk to 1,196,000 in 1966 and revived to 1,543,000 in 1968. However, recent interest rate increases have again depressed housing starts so that it appears starts will drop to an annual rate of of 1,000,000 in 1969, or a decline of approximately 33% from 1968. This is in the face of strong indications of an extremely high demand for housing. The long term demand for residential construction is generally measured by four factors: net housing additions, housing vacancies, housing removals and mobile homes. All of these consistently indicate a pent-up demand for 1,800,000 housing starts in 1969.

Further, because of the general lack of money supply, funds which would normally be channeled into home mortgages, such as loans by commercial banks and savings and loan institutions have been absorbed by industry. Even when potential home purchasers are willing to pay the very high interest rates, they are having difficulty obtaining funds from banks because of competition with commercial bank customers at the prime rate. Also, the increase in interest rate has led to problems in granting loans because of some state usury laws. For example, in Illinois up until recently, it was usurious to loan mortgage money to individuals at a charge of more than 7%, although loans to corporations at any percentage could be made. Under these circumstances, further problems in financing were created for the housing market.

The gypsum industry is undoubtedly unique in its dependence on residential construction. In 1967, approximately 95% of its revenue came from the sale of construction products with 75% being accounted for by products which are primarily used in residential construction. This is much greater than any other mining industry. Other typical mining industries manufacturing construction products had from 9% to 30% of their production accounted for by residential construction products.

While the government's anti-inflationary policy has caused a downtrend in residential construction, government policy, particularly with regard to urban areas, is to stimulate such construction. Currently, the Department of Housing and Urban Development (HUD) headed up by George Romney is actively engaged in a program which has as its objective the development of 3,000,000 residential units per year by 1975, or a growth of approximately 20% per year. In order to implement this program, HUD has started "Operation Breakthrough" and to this end it has declared it will spend $15,000,000 in a research and development program where it will be soliciting bids from various companies in the construction areas including several members of the Gypsum Association. It is recognized that this program will require innovation and a change of existing construction patterns. Such innovation and change of course requires the large expenditures of funds by the various companies with no guarantee of return.

So far, there has been no money appropriated by Congress to implement substantial portions of this research and the bulk of the money must be provided by private ventures.

The gypsum industry has demonstrated its initiative and leadership in the development of low cost urban residential housing. Currently, two of the industries' top executives are serving on the President's Committee for urban development. The gypsum industry has or plans to expend over $10,000,000 of its own funds into low cost urban redevelopment. Programs have either taken place or are contemplated in urban centers in New York, Chicago, Detroit, Cleveland and Columbus, Ohio, and involved work not only with the City administrations but local groups and unions. As with any pioneering effort, this has been extremely time consuming and expensive and presently has no guide lines. One of the chief elements in this program has been work with the unions to develop new apprentice programs for the use of gypsum products. For example, arrangements have been currently worked out whereby it is only necessary for a two-year apprentice program to qualify as a journeyman for the hanging of wallboard as contrasted with a general four-year program to becoming a journeyman carpenter. This not only reduces costs but hastens the entry of minority groups into the construction trades.

To the best of our knowledge, the gypsum industry is the only mining industry so completely engaged in a program of urban development. Members of the gypsum industry hope to continue this program not only to stimulate use of their products but as part of their responsibilities as corporate citizens. The industry hopes to participate in "Operation Breakthrough" and other new programs for urban and residential construction.

It is estimated the reduction in percentage depletion rates proposed by the House would cost the gypsum industry approximately $825,000 per year in increased taxes. This coupled with reduction of revenues resulting from the government tight money anti-inflation policy and a cutback in federally financed construction programs is a triple blow on this one industry which will reduce the cash funds available to the gypsum companies. Such reduction, of course, comes at a time when it is most desirable to increase expenditures to help residential housing in general and to attack the revolutionary problems which confront the inner city.

For all of these reasons, if the Congress decides to reduce percentage depletion rates generally, the gypsum industry requests that it be exempted. Such an exemption would be similar to the exemption granted residential construction from the general cutback on accelerated depreciation rates in the House passed Bill. The same policy which dictated no change in depreciation for residential housing should also dictate no change in the depletion granted to the industry whose output is most heavily committed to such construction.

Specifically, the gypsum industry requests the words "gypsum" and "anhydrite" be added after the word "copper" in Section 501(a)(3)(A) of the House Bill so that gypsum and anhydrite from domestic sources, along with gold, silver, copper and iron ore, will be excluded from any general cutback in depletion voted by the Congress.

We thank you for the opportunity to present our views.

The CHAIRMAN. Senator Allott has arrived in the room while we were hearing the last witness, and I will call Senator Allott at this time.

STATEMENT BY HON. GORDON ALLOTT, A U.S. SENATOR FROM THE STATE OF COLORADO

Senator ALLOTT. Mr. Chairman, members of the committee, I appreciate the opportunity to appear before you this morning to discuss three provisions of H.R. 13270 which are of paramount concern to the Rocky Mountain region.

These are:

1. The proposed change in the point of application of the oil shale depletion allowance.
2. The change in the depletion allowance for molybdenum.

3. The inequitable ramifications of those provisions of H.R. 13270 which require divestiture by all foundations of the voting stock of a business enterprise.

I. Oil Shale Depletion Allowance

I invite the committee's attention to the proposed change in the point of application of the oil shale depletion allowance which is found on page 281 of H.R. 13270. This provision amends section 613(c)(4) of the Internal Revenue Code to permit the depletion allowance on the oil shale to be taken after the retort process. This important change is accomplished by simply adding a new subparagraph "(H)" to section 613(c)(4) which defines those treatment processes considered as mining.

Mr. Chairman, this is a sample of oil shale as it comes out of the ground, and I will leave this with you to examine.

Obviously, rock in this State has no commercial value. To apply a 15 percent depletion allowance on rock in this state is meaningless. This is the rock as it comes out of the ground. This oil shale must undergo complicated and expensive retort processes in order to derive the liquid kerogen necessary for the production of oil.

Only after the completion of the retort process, therefore, is there a glimmer of economic value. The House bill recognizes this economic reality and would apply the depletion allowance to the postretort stage of processing.

This is but an infinitesimal fraction of the enormous reserves which are found in Colorado, Wyoming and Utah. It is estimated that in Colorado alone 800 billion barrels of oil lie embedded in the oil shale formations. A great portion of this treasure house of energy resource is owned by the Federal Government.

Despite the fact that these fantastic reserves have been known for over a hundred years, the development of a viable oil shale industry remains a complete nullity.

This country has failed to develop an economic method of converting this rock into liquid petroleum. Costs of production have been too great to offer industry the incentive to invest the necessary capital to develop commercial production facilities. As was pointed out in the 1967 hearings before the Antitrust and Monopoly Subcommittee, the magnitude of investment for a 50,000 barrel per day mine and retort facility exceeds $100 million.

Failure to develop realistic and equitable Federal tax incentives has had a direct bearing on the unwillingness of business management to commit the huge blocks of capital requisite for the development of an oil shale industry.

Mr. Chairman, I want to assure members of this committee that industry has not been timid in the expenditure of capital for research and development to determine the most feasible method of producing shale oil from oil shale. It has been estimated that at least $100 million has been spent by both private industry and the Federal Government to test the economic feasibility of oil shale production.

These research and development expenditures have only succeeded in proving that it is economically infeasible to produce shale oil under the present tax structure. The retention of the House proposal as it now is would be the first step on the road to providing the necessary economic incentives to create a viable oil shale industry.

Mr. Chairman, the administration has opposed the retention of this provision in the House bill. The administration has proposed an additional incentive "should be granted in terms of the research and development objective."

The administration feels this proposal would constitute "an important breach in the principle that percentage depletion is to be computed on gross income from mining, not manufacturing to any extent."

Mr. Chairman, I believe these objections simply are not in accord with the facts.

First, as I previously stated, government and industry have invested nearly $100 million in oil shale research and development. Accordingly, to suggest that further research and development efforts should be expended simply overlooks the realities of the present situation and its economics.

With regard to the administration's second objection, under existing law, treatment processes are considered mining for the purpose of applying the depletion allowance to ores or minerals which are not customarily sold in the form of the crude mineral product (26 United States Code 613(c)(4)(D)). Examples covered by this section are: lead, zinc, copper, gold, silver, uranium, fluorspar ores and potash.

Mr. Chairman, present tax law even considers the loading of coal or sulfur for shipment as part of the treatment process. The House bill only extends the treatment process to include the retorting of oil shale. As such, it is only "half a loaf" as compared to coal and sulfur since even after retorting the shale oil is not acceptable as refinery feedstock because retorted shale oil is hydrogen-deficient and requires hydrogenation before it is acceptable to a pipeline.

I point this out because the proposed definition of "treatment processes" specifically excludes hydrogenation, refining, or any other processes subsequent to retorting as they may apply to oil shale.

For the present, however, I only ask that the House-passed provision be retained to include these other necessary commercial processes for marketability of the product. Let us see what effect this provision will have upon the possibility of creating an incentive for the development of an oil shale industry. If the present provision does not provide sufficient inducement I may be back. In fact, Mr. Chairman, I will promise to be back.

Mr. Chairman, despite the importance of the recent North Slope discovery, projections indicate a requirement for a mix of conventional and synthetic fuels in the future. Because of the long leadtime involved, action is necessary now to provide the tax climate to assure the existence of an adequate oil shale industry in the 1980's.

The tremendous capital outlays, the development of advanced technology, and the long leadtime should allay any sudden fear of a flood of shale oil on the market.

Mr. Chairman, this provision in H.R. 13270 is an investment in the future energy needs of this country and a hedge against potential interdiction of foreign supply lines. As such, to paraphrase Neil Armstrong's famous exclamation from the moon, this would be the first small step for oil shale development in the Rocky Mountain region, but it would be a giant leap forward for the economic development of this most important energy resource.

Mr. Chairman, at this point in the hearing record, I would like to have inserted the statement of the Colorado Governor's Oil Shale Advisory Committee on this same subject. (See p. 4373.)

Senator ALLOTT. II. Molybdenum Depletion Allowance:

On another subject, Mr. Chairman, and with the committee's indulgence, I should like to point out one inequity in our tax structure which the House bill fails to correct.

This involves the question of equitable depletion treatment for molybdenum.

Mr. Chairman, molybdenum is the only nonferrous metal to be excluded from the 23 percent depletion allowance category set forth in section 613(b)(2) of the Revenue Code. Under present law molybdenum receives 15 percent under the provisions of section 613(b)(6). It is my belief that due to its unique properties, it should receive the same depletion treatment afforded those industrial metals enumerated in section 613(b)(2). Molybdenum is the only ferro-alloy not included in this section.

As you know, the House bill would reduce the depletion allowance on these minerals contained in section 613(b)(2) industrial metals down to 17 percent. Molybdenum would be reduced under the House bill to 11 percent.

I want to make it clear that the objection I raise here today is the continued discrimination against molybdenum. My concern is that this continued discrimination against molybdenum is due to an oversight and perhaps a lack of information with regard to the strategic uses and unique characteristics of this metal.

Molybdenum is a vitally important metal which is chiefly used by the steel industry as an alloying element. Over 80 percent of molybdenum produced is used in this alloying with iron and steel in making tool steels, stainless steels, and a wide range of constructional alloy steels, as well as special steels for corrosion resistance and elevated temperature service.

Molybdenum also has smaller but growing use in such "space age" applications as rocket motors and electronics. Molybdenum was classified as a strategic mineral under the Korean excess profits tax and it has been stockpiled as a strategic and critical material by the U.S. Government.

At the present time molybdenum is entitled to only a 15-percent percentage depletion allowance, whereas all the other important ferro-alloys used in making alloy steel are entitled to 23 percent. These other alloys are chromite, columbium, manganese, nickel, tungsten, and Vanadium.

There appears no reasonable basis for this discrimination. In fairness, molybdenum should be included in the 23 percent category. Equity would seem to require that it should be treated no differently. than other ferro-alloy materials and, therefore, it would be appropriate at this time to specifically include molybdenum in section 613(b)(2)(B) of the Internal Revenue Code.

III. Requirement of Divestiture by all foundations of voting stock in business enterprises:

Finally, Mr. Chairman, I should like to direct the committee's attention to certain inequitable results which would develop if the proposed revision of section 4943 of the Internal Revenue Code actually became law. The provision in question is found at page 34 of H.R. 13270. This section provides that if a foundation owns more than 20 percent of the voting stock of a business enterprise it must divest itself of sufficient stock to bring such holdings to no more than 20 percent.

Mr. Chairman, we have several unique foundations in Colorado, the charitable purposes of which would be severely imperiled if this proposed change actually becomes law—among these are the Helen G. Bonfils Foundation and the El Pomar Foundation.

In 1961, the Helen G. Bonfils foundation received a gift of a 42 percent stock interest in the Denver Post, subject to the restriction that the stock was to be sold at a fair price to a trust for the benefit of the employees of that newspaper as the employees purchase interests in the trust. The object of this plan was to insure that:

(a) the value of the stock would be devoted to charitable purposes, and

(b) The Post would survive as a vigorous and independent newspaper owned by its employees. More than 400 Denver Post employees have purchased interests in the trust in expectation of the full implementation of the plan.

The Post stock was thus received by the foundation subject to a plan requiring complete disposition of such stock in a manner serving the public interest in maintaining independent newspapers. Accordingly, no substantial legislative purpose would be frustrated if this stock were required to be disposed of at a rigidly fixed time schedule as contemplated by the provisions of the House bill dealing with this subject.

This situation will be more fully explained by former Ambassador Arthur Goldberg when he appears before your committee on October 8.

Mr. Chairman, the El Pomar Foundation of Colorado Springs is another Colorado foundation which may be severely hampered, in fact I believe it will, in its charitable activities if this divestiture provision of the House bill is enacted into law.

Created under the provisions of the will of Spencer Penrose in 1937, 32 years ago, the El Pomar Foundation contributes to public, educational, scientific, and other benevolent purposes in order to encourage and promote the well-being of the inhabitants of Colorado. The entire State has been the beneficiary of this unique and worthwhile foundation.

One of the principal assets of the foundation, however, is the El Pomar Investment Co. which in turn owns and operates the Broadmoor Hotel. The directors of the El Pomar Investment Co. have consistently placed service to the community and the general welfare of the inhabitants high on their list of priorities. Like the Green Briar and the Homestead, the Broadmoor has placed primary emphasis on the excellence of its service and facilities, far above the level which would be maintained to maximize profits. I am sure that those of you who have stayed at the Broadmoor will undoubtedly agree with me that this is an outstanding asset to Colorado.

I am very concerned that under the proposed revision of section 4943 suggested in the bill, the El Pomar Foundation will be required to divest itself of its relationship with the Broadmoor Hotel.

I have been particularly impressed by the arguments developed in opposition to the enactment of the proposed section 4943 as they relate to the El Pomar Foundation. Because these arguments are developed in greater detail by Mr. Russell Tutt, president of the El Pomar Foundation, I should like to ask that his entire statement be included at the conclusion of my remarks on this subject.*

I may say, Mr. Chairman, Mr. Tutt has foregone his own time before this committee in order to conserve the time of the committee, but his statement is very pertinent and very vital.

In conclusion, I believe that there is a great deal of merit in enacting certain limitations on the activities of foundations which are clearly beyond the realm of charitable or benevolent concern. On the other hand, I do believe that amendments to section 4943 might be adopted to assure that this section is structured in such a way so as to assure that foundations exist for charitable purposes and not for perpetuating donor control or for tax evasion.

Mr. Chairman, and members of the committee, I thank you for your attention on these important matters this morning, these three important matters as they affect my own State in particular.

I shall be happy to answer any questions I can.

Senator ANDERSON. I desire to take my time to congratulate my colleague on a fine statement. Molybdenum is far more important to his State of Colorado than to mine of New Mexico, but it is still important and we are very happy to have his support.

Are there questions?

Senator ALLOTT. I thank the Senator very much.

Senator ANDERSON. On the foundation question—regarding El Pomar —this involves not only a hotel but an office building also. Didn't the foundation build a new office building in Colorado Springs?

Senator ALLOTT. I do not know. None that I know offhand. You may have in mind the new office building that was built on the site of the Antlers Hotel site. There is a new Antlers Hotel and a new office building there. I think that may be the one the Senator has in mind, but there may be one that I do not know about.

Senator ANDERSON. I guess I am wrong and you are right. But it is a fine venture and a fine thing.

Senator ALLOTT. Incidentally, there is no connection between the two.

Senator BENNETT. I have no questions except to join my chairman in expressing my great satisfaction and my appreciation to my colleague from Colorado for this presentation of three distinct problem parts of this bill.

Senator ANDERSON. Senator Curtis?

Senator CURTIS. Mr. Chairman, I want to congratulate our colleague. I agree with all three of his premises. I might call attention to the fact that the divestiture provisions of the House bill relating to foundations will not bring in one dime of revenue. It cannot be justified on any revenue basis. It should be deleted from the bill entirely. Your statement is so valuable I wonder if the distinguished Senator from Colorado would have any objection if we propounded a unanimous consent request asking that that part of your statement relating to foundations be printed with the testimony that will be taken

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*The statement of the El Pomar Foundation appears in part 6 of these hearings.

in reference to foundations by other witnesses. Would you have objection to that?

Senator ALLOTT. I would have no objection to it, and I appreciate the Senator's suggestion. I mixed these three together because I thought it would save the time of the committee and it was the committee's staff suggestion.

Senator CURTIS. Mr. Chairman, I ask unanimous consent that the statement of the Senator from Colorado with respect to foundations be incorporated in our permanent printing of our hearings along with the testimony of other witnesses pertaining to foundations.

Senator ANDERSON. I am sure that will be agreeable. Without objection that will be done.

Senator Gore?

Senator GORE. In this atmosphere of euphoria, and because of my friendship with the distinguished Senator from Colorado, with regret I suggest that he raises a very important and a very costly principle which would almost double the depletion allowance for oil shale. Though I disagree with the very principle of percentage depletion—I think it is entirely erroneous—I nevertheless have recognized through the years that a very important factor, if, unfortunately we are to have such a formula for tax reduction, is the point at which it is applied.

The Sentaor will recall that at one time it was necessary for Congress to enact a bill (which I introduced) urged by President Eisenhower to prevent steel companies from taking percentage depletion on bolts and nuts. What you propose here, and what is in the House bill, is percentage depletion on a manufacturing process.

Now, if this is permitted for oil shale, I respectfully suggest that soon all other minerals would be asking for the same thing, so if this is approved, it will be a precedent that I predict will be very costly. It may well be, Senator Allott, that the country needs to subsidize the development of the oil shale resource, and I am willing to consider it. But not in this form. For this would be far more costly than an outright subsidy would be.

Senator ALLOTT. May I say to my good friend this: You have up there somewhere on the desk the piece of oil shale which I brought with me. I am not sure that I have made a clear presentation to the Sentaor of what the situation is.

The House provision is not a costly process or a costly suggestion for the reason that the provision in the law now, which puts oil shale in the 15 percent category, is entirely meaningless, because as applied to the mine process, that piece of mining product, that piece of rock, there is nothing to which a depletion allowance can be applied, because it is worthless, at least as far as any known uses presently are known. It is worthless as it comes out of the ground.

Now, the retorting process. There have been millions spent by various oil companies and by the Federal Government. The Federal Government spent at Anvil Point some $18 to $20 million in research on oil shale in the 1950's. It terminated in the latter part of the 1950's. Now the retorting process in one form or another consists of heating the shale to a point where it will give up the carboniferous material known as kerogen, which is embedded in that rock. When it is heated to a certain temperature, the rock will give up this material, and then you have a very raw form of oil.

May I just finish to make this definition clear. Then after that, you really get to the refining and manufacturing process, because it will take huge amounts of water, for example, to provide the hydrogenation and for the reduction of the high sulfur content of this by refining it, before it can be put in a pipeline for any kind of use.

Senator GORE. Senator Allott, I thank you for your able explanation. You have succeeded in making the point clearer than I could. You have described graphically that you are asking for, you are supporting, a provision to give percentage depletion for a manufacturing process.

I suggest to you that if we start that, then it will be tremendously costly, as one mineral after another follows the precedent.

Senator ALLOTT. Well I would suggest to the Senator that in the case of coal, for example, the depletion process even applies to the loading of the coal, as I had in my statement here, and it includes much more than that. The same is true with sulfur. I reiterate, present law even considers the loading of coal or sulfur for shipment as a part of the treatment process.

I admit that this is a matter that has to be given thought, but at the present there is no depletion allowance at all for shale oil, because 15 percent of nothing is nothing, no matter how we figure it, and if we move it to the first retorting process, where you really just sweat out of this rock the raw material, then you have a meaningful depletion allowance for the first time.

But until that time, the 15 percent of nothing is nothing.

Senator MILLER. I want to join my colleagues in commending the Senator from Colorado for an excellent statement.

On the point of the colloquy between the Senator from Tennessee and the Senator from Colorado, it seems to me that there is precedent in the law, precedent in the committee action on this subject of making percentage depletion meaningful.

We went all through this about 8 or 9 years ago in connection with the fire clay problem, of what constitutes a readily marketable condition, and if you take a very restrictive view, as the Internal Revenue Service did, the amount of percentage depletion allowance became rather meaningful. But if you took it according to the practice that had been going on for years in the industry, taking the percentage or applying the percentage depletion to the product in a readily marketable condition, that was something else. Well, the Congress about 8 or 9 years ago tried to do something about this, so I think there is precedent for the position taken by the Senator from Colorado.

I will add that your argument in connection with the molybdenum seemed to me to be very persuasive, and with respect to the foundation problem, I think you have pointed up the need for this committee to go into the foundation provisions in the House-passed bill with a great deal of care.

Granted that the House is trying to do something about abuses, it seems to me that we have to be very careful that the abuses that are covered are not covered in such a way as to destroy some legitimate foundations.

Senator ALLOTT. I want to thank the Senator very much. If the committee would indulge me for about 30 seconds, I am sorry that the Senator from Tennessee had to leave the room for a moment, but referring again to title 26 of the code, article 613(b)(4), and then I want to refer to subparagraphs (a), (b), (c), (d), (e), (f), (g) and (h). I am just going to read a couple of these to show that the request for oil shale is not out of line here at all in conformity with the action of Congress.

The title of this is "Treatment Processes Considered as Mining". "(a) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent free sink and loading for shipment.

"(b) In the case of sulfur recovered by the Frasch process—cleaning, pumping to vats, cooling, breaking, and loading for shipment."

I won't read the others but of these particular sections, subsection (A) through (H) are not in the record, I would particularly like to have them included in the record at this point in my remarks, or at the conclusion of my remarks about the oil shale.

Senator ANDERSON. Without objection that will be done.

(The material referred to follows:)

TITLE 26.—INTERNAL REVENUE CODE

§ 613. PERCENTAGE DEPLETION

(a) General rule

In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 5 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) Percentage depletion rates

The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

(2) 23 percent—

(A) sulfur and uranium; and

(B) if from deposits in the United States—anorthosite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc.

(3) 15 percent—

(A) metal mines (if paragraph (2)(B) does not apply), rock asphalt, and vermiculite; and

(B) if paragraph (5)(B) does not apply, ball clay, bentonite, china clay, sagger clay, and clay used or sold for use for purposes dependent on its refractory properties.

(4) 10 percent—asbestos (if paragraph (2) (B) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(5) 5 percent—

(A) gravel, mollusk shells (including clam shells and oystershells), peat, pumice, sand, scoria, shale, and stone, except stone described in paragraph (6);

(B) clay used, or sold for use, in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products; and

(C) if from brine wells—bromine, calcium chloride, and magnesium chloride.

(6) 15 percent—all other minerals (including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (2)(B) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water, or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

(c) *Definition of gross income from property*

For purposes of this section—

(1) *Gross income from the property*

The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining*

The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) *Extraction of the ores or minerals from the ground*

The term "extraction of the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

(4) *Treatment processes considered as mining*

The following treatment processes were applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

(A) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(B) in the case of sulfur recovered by the Frasch process—cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(C) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment;

(D) in the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit;

(E) the pulverization of talc, the burning of magnesite, the sintering and nodulizing of phosphate rock, and the furnacing of quick-silver ores;

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln food into the kiln, but not including any subsequent process;

(G) in the case of clay to which paragraph (5)(B) of subsection (b) applies—crushing, grinding, and separating the mineral from waste, but not including any subsequent process; and

(H) any other treatment process provided for by regulations prescribed by the Secretary or his delegate which, with respect to the particular ore or mineral, is not inconsistent with the preceding provisions of this paragraph.

(5) *Treatment processes not considered as mining*

Unless such processes are otherwise provided for in paragraph (4) (or are necessary or incidental to processes so provided for), the following treatment processes shall not be considered as "mining" electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping.

(d) *Application of percentage depletion rates to certain taxable years ending in 1954*

(1) *General rule*

At the election of the taxpayer in respect of any property (within the meaning of the Internal Revenue Code of 1939), the percentage specified in subsection (b) in the case of any mine, well, or other natural deposit listed in such subsection shall apply to a taxable year ending after December 31, 1953, to which the Internal Revenue Code of 1939 applies.

(2) *Method of computation*

The allowance for depletion, in respect of any property for which an election is made under paragraph (1) for any taxable year, shall be an amount equal to the sum of—

(A) that portion of a tentative allowance, computed under the Internal Revenue Code of 1939 without regard to paragraph (1) of this subsection, which the number of days in such taxable year before January 1, 1954, bears to the total number of days in such taxable year; plus

(B) that portion of a tentative allowance, computed under the Internal Revenue Code of 1939 (as modified solely by the application of paragraph (1) of this subsection), which the number of days in such taxable year after December 31, 1953, bears to the total number of days in such taxable year.

(Aug. 16, 1954, ch. 736, 68A Stat. 208; Sept. 2, 1958, Pub. L. 85-866, title 1, § 36 (a), 72 Stat. 1633; June 30, 1960, Pub. L. 86-564, title III, § 302 (a), (b) 74 Stat. 291; Oct. 16 1962, Pub. L. 87-834, § 13(e), 76 Stat. 1034; Sept. 2, 1964, Pub. L. 88-571, § 6(a), 78 Stat. 860.)

AMENDMENTS

1964—Subsec. (b)(2)(B), (6). Pub. L. 88-571 inserted "beryllium" following "antimony" in subpar. (2)(B), and deleted "beryl" following "baurite" in both subpars. (2)(B) and (6).

1962—Subsec. (a). Pub. L. 87-834 inserted provisions requiring the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property to be decreased by an amount equal to so much of any gain which is treated under section 1245 as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and is properly allocable to the property.

1960—Subsec. (b)(3), Pub. L. 86-564, § 302(a)(1), limited the 15 percent allowance for ball clay, bentonite, china clay, and saggar clay to cases where paragraph (5)(B) does not apply, and authorized a 15 percent allowance, if paragraph (5)(B) does not apply, for clay used or sold for use for purposes dependent on its refractory properties.

Subsec. (b)(5). Pub. L. 86-564, § 302(a)(2), substituted provisions authorizing a 5 percent allowance for clay used, or sold for use, in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products for provisions which authorized a 5 percent allowance for brick and tile clay.

Subsec. (b)(6). Pub. L. 86–564, § 302(a)(3), eliminated provisions which authorized a 15 percent allowance for refractory and fire clay. See subsec. (b)(3) of this section.

Subsec. (c)(2). Pub. L. 86–564, § 302(b)(1), substituted "the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto)" for "the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products", and "such treatment processes" for "the ordinary treatment processes."

Subsec. (c)(4). Pub. L. 86–564, § 302(b)(2), substitued "The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611" for "The term 'ordinary treatment processes' includes the following" in the opening provisions, included cleaning in cl. (B), substituted "ores or minerals which" for "minerals which" and included substantially equivalent processes in cl. (C), included uranium and minerals which are not customarily sold in the form of the crude mineral product and substituted "from the ore or the mineral or minerals from other material from the mine or other natural deposit" for "from the ore, including the furnacing of quicksilver ores" in cl. (D), included the furnacing of quicksilver ores in cl. (E), and added cls. (F)—(H).

Subsec. (c)(5). Pub. L. 86–564, § 302(b)(2), added subsec. (c)(5).

1958—Subsec. (d). Pub L. 85–866 added subsec. (d).

EFFECTIVE DATE OF 1964 AMENDMENT

Section 6(b) of Pub. L. 88–571 provided that: "The amendments made by subsection (a) [to this section] shall apply to taxable years beginning after December 31, 1963."

EFFECTIVE DATE OF 1962 AMENDMENT

Amendment of subsec. (a) of this section by Pub. L. 87–834 applicable to taxable years beginning after Dec. 31, 1962, see section 13(g) of Pub. L. 87–834, set out as a note under section 1245 of this title.

EFFECTIVE DATE OF 1960 AMENDMENT

Section 302(e) of Pub. L. 86–564, as amended by Pub. L. 86–781, § 4, Sept. 14, 1960, 74 Stat. 1018, provided that:

"(1) In general.—Except as provided in paragraph (2), the amendments made by subsections (a) and (b) [to subsecs. (b), (3), (5), (6), (c), (2), (4), (5) of this section] shall be applicable only with respect to taxable years beginning after December 31, 1960.

"(2) Calcium carbonates, etc.—

"(A) Election for past years.—In the case of calcium carbonates or other minerals when used in making cement, if an election is made by the taxpayer under subparagraph (C)—

"(i) the amendments made by subsection (b) [to subsecs. (b), (3), (5), (6), (c), (2), (4), (5) of this section] shall apply to taxable years with respect to which such election is effective and

"(ii) provisions having the same effect as the amendments made by subsection (b) [to subsecs. (b), (3), (5), (6), (c), (2), (4), (5) of this section] shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to taxable years with respect to which such election is effective in lieu of the corresponding provisions of such Code.

"(B) Years to which applicable.—An election made under subparagraph (C) to have the provisions of this paragraph apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which—

"(i) the assessment of a deficiency,

"(ii) the refund or credit of an overpayment, or

"(iii) the commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this paragraph [Sept. 14, 1960] by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this paragraph.

"(C) Time and manner of election.—An election to have the provisions of this paragraph apply shall be made by the taxpayer on or before the 60th day after the date of publication in the Federal Register of final regulations issued under authority of subparagraph (F), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

"(D) Statutes of limitation.—Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the application of the amendments made by subsection (b) [to subsecs. (c), (2), (4), (5) of this section] may be made with respect to any taxable year to which such amendments apply under an election made under subparagraph (C), and the period within which a claim for refund or credit of an overpayment attributable to the application of such amendments may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subparagraph (C). An election by a taxpayer under subparagraph (C) shall be considered as a consent to the application of the provisions of this subparagraph.

"(E) Terms; applicability of other laws.—Except where otherwise distinctly expressed or manifestly intended, terms used in this paragraph shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this paragraph as if this paragraph were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

"(F) Regulations.—The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this paragraph."

EFFECTIVE DATE OF 1958 AMENDMENT

Subsec. (d) of this section applicable to taxable years beginning after Dec. 31, 1953, and ending after Aug. 16, 1954, see section 1 (c) of Pub. L. 85–866, set out as a note under section 165 of this title.

REFUND OR CREDIT OF OVERPAYMENTS; LIMITATIONS; INTEREST

Section 36 (b) of Pub. L. 85–866 provided that: "If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) of this section [adding subsec. (d) of this section] is prevented on the date of the enactment of this Act [Sept. 2, 1968], or within 6 months from such date, by the operation of any law or rule of law (other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 6 months from such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by subsection (a) of this section [adding subsec. (d) of this section]."

ELECTION FOR CLAY AND SHALE USED IN MANUFACTURE OF CLAY PRODUCTS

Pub. L. 87–312, Sept. 26, 1961, 75 Stat. 674, provided:

"That (a) *Election for past years.*—In the case of brick and tile clay, fire clay, or shale used by the mineowner or operator in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products (without regard to the applicable rate of percentage depletion), if an election is made under subsection (c), for the purpose of applying section 613(c) of the Internal Revenue Code of 1954 [subsec. (c) of this section] (and corresponding provision of the Internal Revenue Code of 1939) for each of the taxable years with respect to which the election is effective—

"(1) gross income from the property shall be 50 per centum of the amount for which the manufacured products are sold during the taxable year except that with respect to such manufactured products, gross income from the property shall not exceed an amount equal to $12.50 multiplied by the number of short tons used in the manufactured products sold during the taxable year, and

"(2) for purposes of computing the 50 per centum limitation under section 613(a) of the Internal Revenue Code of 1954 [subsec. (a) of this section] (or the corresponding provision of the Internal Revenue Code of 1939), the taxable income from the property (computed without allowance for depletion) shall be 50 per centum of the taxable income from the manufactured products sold during the taxable year (computed without allowance for depletion).

"(b) *Years to which applicable.*—An election made under subsection (c) to have the provisions of this section apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which—

"(1) the assessment of a deficiency,

"(2) the refund or credit of an overpayment, or

"(3) the commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this Act [Sept. 26, 1961] by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this Act [Sept. 26, 1961].

"(c) *Time and manner of election.*—An election to have the provisions of this section apply shall be made by the taxpayer on or before the sixtieth day after the date of publication in the Federal Register of final regulations issued under authority of subsection (f), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

"(d) *Statutes of limitation.*—Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the election under subsection (c) may be made with respect to any taxable year for which such election is effective, and the period within which a claim for refund or credit of an overpayment attributable to the election under such subsection may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subsection (c). An election by a taxpayer under subsection (c) shall be considered as a consent to the application of the provisions of this subsection.

"(e) *Terms; applicability of other laws.*—Except where otherwise distinctly expressed or manifestly intended, terms used in this section shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this section as if this section were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

"(f) *Regulations.*—The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this sections."

ELECTION FOR QUARTZITE AND CLAY USED IN PRODUCTION OF REFRACTORY PRODUCTS

Pub. L. 87–321, § 2, Sept. 26, 1961, 75 Stat. 683, provided that:

"(a) *Election for past years.*—If an election is made under subsection (c), in the case of quartzite and clay used by the mine owner or operator in the production of refractory products, for the purpose of applying section 613 (c) of the Internal Revenue Code of 1954 [subsec. (c) of this section] (and corresponding provisions of the Internal Revenue Code of 1939) for each of the taxable years with respect to which the election is effective—

"(1) the term 'ordinary treatment processes' shall include crushing, grinding, and separating the mineral from waste, but shall not include any subsequent process; and

"(2) the gross income from mining for each short ton of such quartzite or clay used in the production of all refractory products sold during the taxable year shall be equal to 87½ percent of the lesser of—

"(A) the average lowest published or advertised price, or

"(B) the average lowest actual selling price, at which, during the taxable year, the mine owner or operator offered to sell, or sold, such quartzite or clay (in the form and condition of such products after the application of only the processes described in paragraph (1) and before transportation from the plant in which such processes were applied). For purposes of this paragraph, exceptional, unusual, or nominal sales or selling prices shall be disregarded. If the mine owner or operator makes no sales of, or makes only exceptional, unusual, or nominal sales of, such quartzite or clay after application of only the processes described in paragraph (1), then in lieu of the price provided for in subparagraph (A) or (B) there shall be used the average lowest recognized selling price for the taxable year for such quartzite or clay in the marketing area of the mine owner or operator published in a trade journal or other industry publication.

"(b) *Years to which applicable.*—An election made under subsection (c) to have the provisions of this section apply shall be effective on and after January 1, 1951, for all taxable years beginning before January 1, 1961, in respect of which—

"(1) the assessment of a deficiency,

"(2) the refund or credit of an overpayment, or

"(3) the commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this Act [Sept. 26, 1961] by the operation of any law or rule of law. Such election shall also be effective on and after January 1, 1951, for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this Act [Sept. 26, 1961].

"(c) *Time and manner of election.*—An election to have the provisions of this section apply shall be made by the taxpayer on or before the 60th day after the date of publication in the Federal Register of final regulations issued under authority of subsection (f), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

"(d) *Statutes of limitations.*—Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the election under subsection (c) may be made with respect to any taxable year for which such election is effective, and the period within which a claim for refund or credit of an overpayment attributable to the election under such subsection may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subsection (c). An election by a taxpayer under subsection (c) shall be considered as a consent to the application of the provisions of this subsection.

"(e) *Terms; applicability of other laws.*—Except where otherwise distinctly expressed or manifestly intended, terms used in this section shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this section as if this section were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

"(f) *Regulations.*—The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section."

CROSS REFERENCES

Allowance of deduction for depletion, see section 611 of this title.

Percentage depletion inapplicable to certain owners of coal or iron ore, see section 631 (c) of this title.

Sale of oil and gas properties, surtax on sale, see section 632 of this title.

Senator ALLOTT. I want to thank the committee very much for the generous consideration and the time they have given.

Senator HANSEN. Mr. Chairman, let me join with my colleagues in complimenting my very distinguished colleague and neighbor from Colorado on the excellent statement he has made this morning. I hope that it will not go unnoticed that the distinguished Senator from Colorado has added in a very meaningful fashion to a better understanding of the importance of considering our energy requirements now.

I think that it has largely gone unnoticed to date that by 1980 we will need to have discovered 87 billion more barrels of oil than we now have. It has also largely gone unnoticed that the very lowest estimate of that discovery cost is $16 billion. So, to take steps now which will enable us to contemplate energy that can be derived from oil shale seems to me to be a very logical suggestion.

In support of the statement of Senator Allott, let me observe that insofar as the point of depletion being concerned, there is no point. There is no oil at all until heat has been applied to the oil shale, and with the kerogen having been subjected to heat it is my understanding, and I would ask the Senator from Colorado if I am correct or not, that at that point and only at that point do vapors start to be released from the oil shale which, when cooled, becomes shale oil. Am I right about that, Senator.

Senator ALLOTT. That is correct.

Senator HANSEN. I think it can be argued successfully that until that point has been reached, we are not talking about manufacturing oil. There is not any oil, period. It is only at that point that oil actually comes into existence.

It seems to me that we ought to be thinking about the foresight that I hope the Congress will manifest in recognizing rising demand and be conscious of our diminishing reserves. We should not think of these things in terms of costs to our people, but in terms of the contribution that wise legislation can make in order that our very critical needs will be fulfilled. To that end, I am certain that you, my colleague from Colorado, have made a most important contribution.

Senator ALLOTT. I thank the distinguished Senator. Both he and the distinguished Senator from Utah have long been interested in the oil shale matter, and are very knowledgeable on it. I am sure that I could not produce anything here which is not within the knowledge of these two Senators, but I am very happy for this opportunity to make this matter clear.

The CHAIRMAN. Thank you very much, Senator, for your fine presentation.

Senator ALLOTT. Mr. Chairman, on another matter: I have received a letter from the trustees of Temple Buell College Trust. May I have this included in the record?

The CHAIRMAN. Without objection.

(The letter, and the statement of the Colorado Governor's Oil Shale Advisory Committee referred to previously, follow:)

TEMPLE BUELL COLLEGE,
Denver, Colo., October 8, 1969.

Re Tax reform bill of 1969.

Senator GORDON ALLOTT,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR ALLOTT: The purpose of this letter is to acquaint you with the crippling effect which the Tax Reform Bill of 1969 would have on Temple Buell College of Denver, Colorado, in the event the bill is passed in its present form.

We call your attention to Section 201(a)(1)(H) found at page 114 of H.R. 13270. This section of the proposed Bill would amend Section 2055 of the Internal Revenue Code. The effect of the section is to deny a charitable deduction for federal estate tax purposes when more than 20% of the stock of a closely held corporation is bequeathed at death.

The apparent reason for the inclusion of Section 201(a)(1)(H) in the bill is to parallel the provisions of Section 4943 as they apply in the area of federal estate taxation. We disagree with this conclusion for the reasons set forth in this letter.

The purported purpose of the Tax Reform Bill is to eliminate inequities in the income tax law and to keep the income tax burden on a fair basis at a level which is tolerable for all taxpayers. The House Ways and Means Committee Report specifically indicated that available time did not permit the inclusion of reform measures relating to estate and gift tax laws or the related problems of tax treatment of property passing at death. Nevertheless, Section 201(a)(1)(H) will affect with heavy tax consequences property passing at death in the case of Temple Buell College as explained hereafter.

Several years ago, Temple H. Buell established an irrevocable endowment trust for Temple Buell College. He has transferred stock of the Buell Development Corporation to that endowment trust. It is anticipated that the largest transfer to the endowment trust will occur on the death of Mr. Buell after which time the endowment trust will have 100% ownership of the Buell Development Corporation. The Buell Development Corporation owns substantial real estate holdings in Colorado including the Cherry Creek Shopping Center in Denver and other shopping centers and properties. If the remaining stock of Buell Development Corporation passes to the endowment trust on the death of Mr. Buell and after the passage of H.R. 13270 in its present form, the endowment trust's share of the federal estate taxes will amount to about $20,000,000. This amount will come directly from the college's endowment and would virtually eliminate the only substantial endowment of the college.

The endowment trust was established to provide independent guidance and judgment in the operation of the Buell Development Corporation. Everyone involved agrees that the Buell Development Corporation has substantially greater value to the College as an operating business than it would in liquidated form. The trust is designed to free the Buell College Board of Trustees from the responsibilities and details of directing and controlling a business enterprise of great magnitude and complexity. It was felt that the Board of Trustees of the College is in a better position to operate and develop the College from an educational standpoint if freed from business responsibilities. The trust provides for three independent trustees, one of whom is the President of the College for purposes of coordination and communication. All income and principal of the trust are devoted exclusively to the benefit of the College without interference or control by persons in any way related to Temple H. Buell.

We recognize that the purpose of the Tax Reform Bill is to break up control by private foundations where such control provides the owner of the corporation with substantial income tax advantages. The application of Section 201(a)(1)(H) to the facts above related does not accomplish this purpose. Since the control of the Buell Development Corporation will pass from Mr. Buell to the Trustees of the endowment trust upon Mr. Buell's death, no useful purpose will be served by eliminating the endowment to the College.

We are aware of your testimony before the Senate Finance Committee relating to the divesture by private foundations of voting stock of business enterprises. Your testimony in this regard is equally applicable to the Temple Buell College endowment trust, but the bill has the further aspect of dealing with estate taxation when there has been no study of these effects and there is an obvious need to consider in greater depth how the proposed law will harm charitable and educational institutions.

As you can well understand, we are vitally concerned with the future of Temple Buell College if H.R. 13270 is passed in its present form. We make several recommendations, any one of which will be effective in eliminating the dire consequences to the College under Section 201(a)(1)(H), to-wit:

1. Entire elimination of Section 201(a)(1)(H) from the bill.
2. Amendment of Section 201(a)(1)(H) of the bill by addition of a proviso substantially as follows:

> "Nothing in this sub subparagraph (H) shall apply to bequests, legacies, devises, transfers or gifts to an organization established prior to December 31, 1969, regardless of the date of death giving rise to the bequest, legacy, devise, or transfer or the date of actual delivery of the gift."

3. Amendment of Section 201(a)(1)(H) by elimination of sub subpart (B) commencing with the words "For a transfer in trust (other than one in which the provisions of subparagraph (A) of this paragraph apply)" and ending with the last provision thereof reading: "(iv) making any taxable expenditures (as defined in Section 4945(d))."

We feel confident that the reforms sought by the Tax Reform Bill of 1969 were not intended to include a situation like the one concerning Temple Buell College. We feel that there is definite need to explore further the many undesirable results which will flow from the passage of Section 4943 of the bill. And we feel that there is definite need to eliminate Section 201(a)(1)(H) until comprehensive study of the state tax laws can be completed. We sincerely hope that you will be able to bring about changes in the proposed bill which will eliminate those results which are socially and equitably unjust and of substantial harm to the community in the broadest terms.

Very truly yours,

TRUSTEES OF TEMPLE BUELL COLLEGE TRUST,
By LAEL S. DEMUTH.

STATEMENT OF THE COLORADO GOVERNOR'S OIL SHALE ADVISORY COMMITTEE BEFORE THE SENATE FINANCE COMMITTEE, SEPTEMBER 30, 1969

The Colorado Governor's Oil Shale Advisory Committe urges the Senate Finance Committee to retain the provisions of House Bill 13270 insofar as such bill applies to the depletion allowance provided for oil derived from oil shale.

I. *House bill 13270 eliminates the present inequity which results from the Treasury's construction of section 613(c)(4) of the 1954 Revenue Code that the retorting of oil shale is not a treatment process considered as mining within the meaning of that section*

Treasury has discriminated against oil produced from oil shale in favor of oil from conventional sources by holding that the 15 percent depletion allowance applies to crushed oil shale rock rather than retorted oil. There is no market for the crushed oil shale rock since the vast quantities of rock required for the processing of oil from shale are too great to permit transportation of crushed oil shale significant distances from the mine portal. Therefore, the only way to determine the value of such crushed rock is to attribute to it that portion of the value of the first marketable product (retorted oil) which the aggregate cost of mining and crushing bear to all costs necessary to obtain such retorted oil. Since mining and crushing constitute approximately 50 percent of the total cost of processing oil from shale prior to hydrogenation or other refining, the crushed oil shale rock has a value of approximately 50 percent of the value of the retorted oil. Thus the effect of Treasury's position is to accord the oil shale industry an effective depletion allowance not of 15 percent, but of approximately 7½ percent. The deterrent effect of Treasury's position upon would-be investors in the oil shale industry is obvious.

Students of the industry look forward to oil shale as a supplemental source of crude to shore up the dwindling domestic reserves. It is inequitable to burden the new industry with a depletion rate which represents less than half of the rate intended by Congress and an even smaller fraction of the rate available to the conventional oil industry.

Treasury's present position not only discriminates against oil from oil shale as compared with conventional oil, but will result in discrimination between different methods of processing oil shale. Each process for the retorting of oil shale will result in a different depletion allowance, depending upon the relative cost of the process to the aggregate costs of mining and crushing. In the event that the extraction of oil from shale by an "in situ" process becomes feasible, the inequities created by the Treasury's position become even more apparent. Since no mining or crushing would be used, the depletion allowance would have to apply to the value of the retorted oil.

The elimination of the inequity by the House Bill is consistent with the intent of the drafters of Section 613(c)(4). It achieves the result which Senator Byrd hoped would be effected by the Secretary of the Treasury in enacting Section 613(c)(4)(H). In explaining the final bill to the Senate, he said:

* * * "The conference agreement also adds a new subparagraph (H) to provide administrative flexibility in the application of this provision by providing that the Secretary or his delegate may by regulation provide for the allowance of any other treatment process which is not specifically denied in the other subparagraphs of paragraph (4). *Your Committee hopes that the Secretary will use this subparagraph to equalize treatment insofar as possible under the different processing techniques and with respect to competitive minerals.*" [Italic supplied for emphasis.]

Since Treasury has failed to avail itself of the remedies provided in Section 613(c)(4)(H), we urge the Senate to eliminate the inequity by adopting the provision already passed by the House.

II. *The House provision is consistent with the intent of Congress in enacting section 613(c)(4)*

Oil shale is clearly a mineral intended to come within the ambit of Section 613(c)(4)(D) as one "which is not customarily sold in the form of the crude mineral product." Retorting is a substantially equivalent process . . . "used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit."

A process virtually identical to the retorting of oil shale is the furnacing of quicksilver ores now included under subparagraph (D) of Section 613(c)(4). The inclusion of retorting of oil shale as a treatment process considered as mining, therefore, does no violence to the spirit or the letter of Section 613(c)(4).

III. *House bill 13270 will not deprive the Treasury of revenue*

Although the commercial production of oil shale is in the final states of development, there is no shale oil production yielding revenue to the Treasury at the present time. Accordingly, enactment of the House provision dealing with oil shale will not adversely affect revenues of the Federal Government. Indeed, enactment of the House provision will eliminate one of the present major obstacles to the development of a new domestic industry needed to supplement domestic sources of petroleum and will add a substantial source of revenue for the United States Treasury.

The CHAIRMAN. Next we will have Mr. John W. Roberts.

STATEMENT OF JOHN W. ROBERTS, PRESIDENT OF SOLITE CORP., RICHMOND, ACCOMPANIED BY RICHARD BRADY, COUNSEL

Mr. ROBERTS. Mr. Chairman, gentlemen, my name is John Roberts, President of Solite Corp., Richmond, Va., a company that has manufacturing and mining activities. I am here today to speak only about our mining activities and appear in behalf of the Expanded Shale, Clay and Slate Institute. I have with me Mr. Richard Brady, counsel for the institute.

The Expanded Shale, Clay and Slate Institute is an industry association representing approximately 80 percent of the production of sintered lightweight aggregate in the United States.

Sintered lightweight aggregate is produced by burning or sintering shales, clays, and slates, to expand or stabilize them and is sold as concrete aggregate to make lightweight concrete. It is competitive with sand, gravel, and crushed stone, and replaces an equal volume of these other concrete aggregates.

The percentage depletion rate for shales, clays, and slates used as lightweight aggregate was raised from 5 to 7½ percent in 1966 by conference action in lieu of a provision approved by the Senate Finance Committee and the Senate which would have treated as a mining process the burning or sintering of shale, clay, and slate used for lightweight aggregate.

This would have restored what all of the industry felt was its allowable cutoff point, and what the courts held until 1965 was its cutoff point. It would have offered encouragement to an industry that grew in size about 600 percent in the previous 15 years, but which has grown only 15 percent in the past 4 years.

The House bill, as part of the general reduction in percentage depletion allowances would cut the rate applicable to lightweight aggregate from 7½ to 5 percent. The proposed rate reductions under the House bill, if enacted, would signal a change in the national minerals policy which provided depletion as a stimulus to encourage people to go into the mining business.

If such encouragement is no longer considered by Congress to be as important to the public interest, this change in policy will be reflected in diminished growth of the mining industry.

The proposed rate reductions under the House bill were not based upon any study of either the lightweight aggregate industry or the mining industry generally. They should be more carefully considered.

For example, the recognition given iron ore in the House bill, under which no reduction is proposed in its 15 percent depletion rate, should also be given to lightweight aggregates because their use in construction effects substantial savings in reinforcing and structural steel with the resultant saving for the Nation of its iron ore.

Lightweight aggregate is a small industry, and the proposed one-third cutback of its percentage depletion deduction amounts to no more than $400,000, and cannot have a significant impact on national revenues.

Individual producers, however, and there are some 70 of them in the United States, will be substantially affected by a one-third cutback in their already modest percentage depletion allowance.

Lightweight aggregate producers need percentage depletion to offer them the incentive to develop deposits of suitable raw materials. The depletion allowance under the House bill of 5 percent based on a pre-kiln cutoff does not offer a satisfactory incentive.

Our institute opposes the proposed reduction in rate applicable to lightweight aggregate and on the other hand urges your consideration of action to be taken regarding clay, shale, and slate on the basis of three possible points of view.

Let me point out that clay, shale and slate suitable for lightweight aggregate is different from that suitable for clay brick, tile, and sewer pipe:

1. If it is the judgment of the Senate Finance Committee that it is in the public interest to encourage investment in the mining industry, and specifically in our segment of the industry because of its contributions to the building industry, we would recommend no reduction in the 7½-percent rate afforded our industry at its present cutoff point.

2. If, however, circumstances dictate at this time a change in national policy regarding the importance of percentage depletion as it relates to the public interest and if it is decided to reduce the rate for all minerals across the board, we would point out that fairness among competitors demands that similar commodities receive the same percentage of reduction. In our case this would involve a reduction to 6 percent instead of the 5 percent proposed in the House bill. The rates applicable to other concrete aggregates competitive with lightweight aggregate are reduced under the House bill by only 20 percent compared with the 33⅓-percent reduction in the lightweight aggregate rate.

3. If you believe, as did the House Ways and Means Committee, that it is in the public interest that certain minerals such as iron ore should receive special consideration, we request, for the same reasons that apply to iron ore, and for the same reasons this committee relied on in 1966, your enactment at this time of the Senate amendment of 1966 to treat as a mining process sintering or burning of shale, clay, and slate used for lightweight aggregate. Other competitive industries such as sand, gravel, and crushed stone get percentage depletion on the selling

price of their depletable mineral products, and lightweight aggregate producers believe they should receive similar treatment.

The maximum tax benefit from a depletion allowance of 5 percent on the selling price of lightweight aggregate is probably no more than $800,000.

The CHAIRMAN. Thank you very much, sir.

(John W. Roberts' prepared statement follows:)

STATEMENT OF JOHN W. ROBERTS ON BEHALF OF EXPANDED SHALE, CLAY AND SLATE INSTITUTE

(1) The Expanded Shale, Clay and Slate Institute is an industry association representing approximately 80 percent of the production of sintered lightweight aggregate in the United States. Sintered lightweight aggregate is produced by burning or sintering shales, clays and slates to expand and stabilize them and is sold as concrete aggregate to make lightweight concrete. It is competitive with gravel, sand and crushed stone and replaces an equal volume of these other concrete aggregates.

(2) The percentage depletion rate for shales, clays and slates used as lightweight aggregate was raised from 5 to 7½ percent in 1966 by conference action in lieu of a provision approved by the Senate Finance Committee and the Senate which would have treated as a mining process the burning or sintering of shale, clay and slate used for lightweight aggregate.

(3) The House bill as part of a general reduction in percentage depletion allowances would cut the rate applicable to lightweight aggregate from 7½ percent to 5 percent.

(4) The proposed rate reductions under the House bill, if enacted, will signal a change in the National minerals policy which provided percentage depletion as a stimulus to encourage people to go into the mining business. If such encouragement is no longer considered by Congress to be as important to the public interest, this change in policy will be reflected in diminished growth of the mining industries.

(5) The proposed rate reductions under the House bill were not based upon any study of either the lightweight aggregate industry or the mining industry generally. They should be more carefully considered. For example, the recognition given iron ore in the House bill, under which no deduction is proposed in its 15 percent depletion rate, should also be given to lightweight aggregates because their use in construction effects substantial savings in reinforcing and structural steel.

(6) Lightweight aggregate is a small industry, and the one-third cutback of its percentage depletion deduction amounts to no more than $400,000 and cannot have a significant impact on National revenues. Individual producers, on the other hand, will be substantially affected by a one-third cutback in their already modest percentage depletion allowances.

(7) Lightweight aggregate producers need percentage depletion to undertake the difficult and expensive project of discovery and development of deposits of suitable raw material for lightweight aggregate. The depletion allowance under the House bill of 5 percent based on a pre-kiln cutoff does not offer a satisfactory incentive to make deposits suitable for lightweight aggregate available to the public with the consequent benefits in quality and cost of construction materials.

(8) The Expanded Shale, Clay and Slate Institute opposes the proposed reduction of the percentage depletion rate applicable to lightweight aggregate and urges in the following order of preference:

(a) Enactment at this time of the Senate amendment in 1966 to treat as a mining process sintering or burning of shale, clay and slate used for lightweight aggregate. Other competitive industries such as sand, gravel and crushed stone get percentage depletion on the selling price of their depletable mineral product, and lightweight aggregate producers believe they should receive similar treatment. The maximum tax benefit from a depletion allowance of 5 percent on the selling price of lightweight aggregate is probably no more than $800,000.

(b) Continuation of the 7½ percent rate for lightweight aggregate.

(c) If no other changes are made in the proposed rate reduction, fairness among competitors demands that shale, clay and slate used as lightweight aggregate be allowed a 6 percent rate, a cutback of one-fifth from the present rate.

The rates applicable to other concrete aggregates competitive with lightweight aggregate are reduced under the House bill by only 20 percent compared with the one-third reduction in the lightweight aggregate rate.

STATEMENT

I am John W. Roberts, a member of the Percentage Depletion Committee of Expanded Shale, Clay and Slate Institute, and am submitting this statement on behalf of all members of the Institute. I am also President of Solite Corporation, Richmond, Virginia, a member company of the Institute. The Institute's members appreciate this opportunity of presenting to the Committee its views on the provisions of Section 501(a) of H.R. 13270.

The Expanded Shale, Clay and Slate Institute is an industry association representing approximately 80 percent of the production of sintered lightweight aggregate in the United States. Sintered lightweight aggregate is produced from clays, shales, and slates by burning or sintering in a rotary kiln or traveling grate. Before burning or sintering there are no significant uses or markets for the clays, shales and slates from which lightweight aggregate can be and is obtained. Burning or sintering expands and stabilizes the raw material to make it suitable for use as lightweight aggregate. Almost 100 percent of the lightweight aggregate produced in the United States is sold as concrete aggregate and usually is mixed with portland cement and water by the consumer to make lightweight concrete. Lightweight aggregate is competitive with gravel, sand and crushed stone and replaces an equal volume of these other concrete aggregates.

Clays, shales and slates used or sold for use as sintered or burned lightweight aggregate are presently authorized percentage depletion at 7½ percent; under the House bill, the allowable rate would be cut to 5 percent. The rate applicable to lightweight aggregate was raised from 5 to 7½ percent under the Foreign Investors Tax Act of 1966. At that time the Senate Finance Committee and the Senate approved an amendment to the Foreign Investors Tax Act which would have amended Code Section 613(c)(4) to provide that the sintering or burning of clay, shale and slate used or sold for use as lightweight aggregate would be considered a mining process. The Senate amendment would not have changed the 5 percent rate. The House had not acted on a bill corresponding to the Senate amendment. Under the conference action, the Senate amendment was eliminated and the new rate category of 7½ percent was created to include clay, shale and slate used or sold for use as sintered or burned lightweight aggregate.* The lightweight aggregate industry had estimated that the maximum tax benefit from the Senate amendment, based upon existing prices and tonnages, probably would be no more than $500,000 annually. The saving under the rate increase has probably been only a minor fraction of the amount that would have been saved under the Senate amendment.

The Expanded Shale, Clay and Slate Institute opposes the proposed reduction in the existing percentage depletion rate for lightweight aggregate. The Institute urges, at the least, (1) continuation of the 7½ percent rate for lightweight aggregate, or preferably, (2) amendment of Code Section 613(c)(4) to treat as a mining process the sintering or burning of clay, shale and slate used or sold for use as lightweight aggregate.

The Institute would also like to draw to the Committee's attention the discrimination between clay, shale and slate used as lightweight aggregate and other competitive concrete aggregates under the House bill. The rate for clay, shale and slate used as lightweight aggregate is reduced from 7½ percent to 5 percent, a one-third cutback. The rate for gravel, sand and crushed stone used as concrete aggregate is reduced from 5 percent to 4 percent, only a one-fifth cutback. If no other changes are made in the proposed rate reductions, fairness among competitors demands that clay, shale and slate used as lightweight aggregate be allowed a 6 percent rate, a cutback of one-fifth from the present rate comparable to the reduction for competitive concrete aggregates. The higher percentage depletion rate for clay, shale and slate used as lightweight appregate recognizes that under present law the percentage depletion allowance for them is subject to cutoff before burning or sintering whereas competitive concrete aggregates get percentage depletion on the selling price. While prices for lightweight aggregate are generally somewhat higher than the prices of heavyweight aggregate with

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*The new rate category also included clay or shale used or sold for use in the manufacture of sewer pipe and brick.

which they compete, there cannot be too much difference between the two; otherwise lightweight aggregate would lose out to heavyweight aggregate.

The basic purpose of the percentage depletion allowance has always been to insure an adequate supply of the Nation's natural resources at a reasonable cost to the consuming public. The percentage depletion allowance recognizes that minerals in the ground have no usefulness to the public unless someone has the courage and persistence to spend substantial amounts of risk capital in searching for, finding, acquiring, developing and making them available to consumers.

Any change in National policy that would adversely affect the growth of the mining industries should be carefully considered. The Ways and Means Committee reported that it believes (1) "that even if percentage depletion rates are viewed as a needed stimulant at the present time they are higher than is needed to achieve the desired beneficial effect on reserves;" and (2) "that there is need to strike a better balance than now exists between the objective of encouraging the discovery of new reserves and the level and revenue cost of percentage depletion allowances." The conclusions of the Ways and Means Committee were not based upon any study of either the lightweight aggregate industry, and especially as the lightweight aggregate industry relates to the iron ore industry, or the mining industries generally. It is unlikely that the Committee even considered the proposed rate reductions in terms of any mining industries other than oil and gas.

The mining of shale, clay and slate for use as lightweight aggregate is a small industry. It consists of approximately 70 plants operating in many parts of the country. In recent years their annual production of aggregates has averaged approximately 7 million tons with an aggregate fair market value of about $45,500,000, although no precise figures are available. The maximum annual percentage depletion deduction based upon the existing 7½ percent rate and the pre-kiln cutoff point is estimated by the industry to be about $1,200,000. The one-third cutback of this deduction, or $400,000, under the proposed rate reduction cannot have a significant impact on National revenues. Individual producers of lightweight aggregate, however, will be substantially affected by a one-third cutback in their already modest percentage depletion allowances. The other provisions of the House bill applicable to all businesses serve whatever may be the reasonable demands of tax reform on the lightweight aggregate industry.

The lightweight aggregate industry needs percentage depletion. Only special shales, clays and slates are expansible to as much as several times their original size when they are subjected to high temperatures for use as lightweight aggregate. Discovery and development of a deposit of suitable raw material for lightweight aggregate is a difficult and expensive project. Deposits that are suitable for cement or brick and tile are not ordinarily suitable for lightweight aggregates. To determine the suitability of deposits for production of lightweight aggregates, samples cannot be appraised by chemical analysis alone. The samples must be actually processed in laboratory or pilot plant equipment to determine if bloating characteristics exist and the firing range is acceptable. The raw mineral may bloat too little and be too heavy or it may bloat too much and lack the necessary strength and stability. Bloating may also occur within a narrow temperature range which results in production problems and makes it difficult to obtain a product of uniform quality. If a material appears to give good results in laboratory and pilot plant tests, then samples of concrete made from the aggregate must be tested for compressive strength, durability under freezing and thawing, modulus of elasticity and many other characteristics to make certain that the aggregates will give good results in actual service.

Even though a deposit of raw material is suitable as to quality, it may not be suitable for development because of other factors. The deposit may lie under an excessive layer of overburden which makes mining too expensive or it may not have access to the necessary water supply, electric power and rail service. The deposit must be located where its production into lightweight aggregates does not violate zoning or other government regulations. If all other factors are favorable, a deposit may still not be economically attractive if it is not within a satisfactory market area.

A depletion allowance of 5 percent based on a prekiln cutoff does not offer a satisfactory incentive for the efforts and expenses needed to seek out shale, clay and slate deposits suitable for lightweight aggregates and to make these deposits available to the public with the consequent benefits in the quality and costs of construction materials.

By virtue of their light weight, aggregates made from expanded shales, clays and slates effect substantial savings in reinforcing and structural steel. In the construction of the Chesapeake Bay Bridge, for example, spanning 4.3 miles of open water, lightweight aggregate was used for the concrete deck. The dead weight of the deck was thereby reduced more than 3 million pounds per mile, as contrasted with ordinary concrete, resulting in a great saving in steel.

Prudent National policy indicates that alone these savings in steel are justification for not reducing lightweight aggregate's percentage depletion allowance. The lightweight aggregate industry should be encouraged in order to make these economies generally available in peacetime, and, of course, it is vital that these savings in steel are available during periods of national defense emergency. The recognition given iron ore in the House bill, under which no reduction is proposed in its 15 percent depletion rate, should also be given to lightweight aggregate because of its beneficial effect on meeting the Nation's demands for steel.

BURNING OR SINTERING AS A MINING PROCESS

As a preferable alternative to continuation of the 7½ percent depletion rate, Code Section 613(c)(4) should be amended to treat as a mining process the sintering or burning of clay, shale and slate used or sold for use as lightweight aggregate. Justification for this proposal was fully documented in materials made available to Congress in 1965 and 1966, at the time the Senate Finance Committee and the Senate voted for the same provision. The reasons in favor of this proposal can be summarized as follows:

1. Other competitive industries such as sand, gravel and crushed stone get percentage depletion on the selling price of their depletable mineral products. Lightweight aggregate producers believe they should receive similar treatment.
2. Other thermal processes including sintering under some circumstances are allowable as mining under the statute. Sintering of iron ore is basically the same as sintering or burning of lightweight aggregate and is allowable under Revenue Ruling 184.
3. Burning or sintering of lightweight aggregate expands and stabilizes the raw minerals. It does effect a significant chemical change or produce a finished or manufactured product.
4. Treatment of burning or sintering as a mining process will promote availability of lightweight aggregate with consequent benefit to the public in quality and cost of construction materials. It will also eliminate needless controversies between the industry and the Internal Revenue Service over the theoretical value of the raw mineral at the pre-kiln cutoff point. Lightweight aggregate is a small industry and the maximum tax benefit from a depletion allowance of 5 percent on the selling price is probably no more than $800,000.

The CHAIRMAN. The next witness will be Mr. Clark Sutherland, chairman of the Clay Pipe Industry Depletion Committee, National Clay Pipe Institute.

STATEMENT OF CLARK SUTHERLAND, CHAIRMAN, CLAY PIPE INDUSTRY DEPLETION COMMITTEE OF AKRON, OHIO

Mr. SUTHERLAND. Mr. Chairman and members of the Senate Finance Committee, I welcome the opportunity to come before you today. I am only going to take about 3 minutes of your very valuable time.

My name is Clark Sutherland. I am president of the Robinson Clay Product Co. of Akron, Ohio. I used to work for the Pacific Clay Products in Los Angeles. I came into the industry 40 years ago as a young geologist graduate from Cal Tech and went to work for a clay sewer pipe company prospecting for clays, in order to keep their plants going.

I have been concerned in this depletion question for a good many years. I would like to say that first of all the clay pipe industry recommends that no reduction be made in the present 7½-percent depletion allowance. We are a small industry. In total, we have only about $100 million sales annually. Our total depletion benefits are pretty hard to determine because of course we have no definite figures, but they are in terms of maybe a half million dollars as a tax advantage or benefit.

Ordinarily many people think of sewer pipe as being a part of the mud industry, but it really is not. We have to use only certain types of clays, to maintain dimensional tolerances. Also we have to obtain high-crushing strengths and other characteristics to meet rigid standards for our product, which demands certain types of clays.

Ordinarily, we use in the normal sewer pipe mix a mixture of shale and fire clay. One of the problems that we face is that traditionally back in the fifties we were allowed a 15-percent rate on the fire clay that we used in the mix, and this was justified after quite a lot of argument with the Treasury Department.

We had to use fire clay in order to obtain certain characteristics of the product. Now, in 1960, we were cut down to a 5-percent rate for all clays which were used in sewer pipe, regardless of whether they were refractory or not. One of the absurdities that resulted, for example, was that the Robinson Clay Product Co. happened to operate both sewer pipe plants and refractory brick plants in the same area, and we literally alternated power shovelfuls of fire clay going into refractory brick and going into sewer pipe, and on one type of use we got 15 percent. On the other type of use we got 5 percent.

We did not use the fire clay for any other reason but we had to use it in the product in order to attain the characteristics which we had to have to meet Federal specifications.

Then back in 1966 we went back to Congress and we talked about our competitive problem with cement, and Congress raised our depletion rates to 7½ percent. But the fire clay portion still is at 7½ percent, so our fire clay really is the only mineral that has been reduced down through the years from 15 down to 5 and then back to 7½.

Under the provisions of the bill that you are now considering, we will be reduced back down to 5 percent, which is clearly, of course, an inequitable situation.

The other factor which we face is that we are in competition with cement. Cement is our principal competitor, both for sewer pipe and for many other applications.

Limestone and the clays used in their mix are allowed 15 percent. How they got that rate on clay was the fact that there was a natural cement rock which contains both clay and limestone. Cement is a calcium aluminum silicate, so that clay is necessary in it. They were allowed 15 percent on that natural cement rock and finally by Treasury regulation all other cement producers were allowed 15 percent on the clay that they added into the mix, whether it be shale or fire clay.

We are in competition with an industry which enjoys 15 percent while we get 7½, and we also have the problem that we had 15 percent, deservedly so, on the fire clay portion, and we have been reduced down to the present 7½ percent.

What we really need in our industry, and to make it equitable, is to have the fire clay portion raised up to the same rate that limestone and the clay that is used in cement enjoys, regardless of whatever happens to them in terms of whether you retain the present 15 percent, or if you take it down to the proposed 11.

For those reasons, I want to say that we first of all need and deserve no reduction in our depletion benefit, and if anything we need an increase. I will be glad to try to answer any questions that I can.

The CHAIRMAN. Thank you.

Senator MILLER. I would like to ask a question or two, Mr. Chairman.

Of course, it seems to me we have to look at this problem from two standpoints; No. 1, the percentage depletion rate.

Mr. SUTHERLAND. Yes.

Senator MILLER. And No. 2, the basic instance in which it is applied, because if you have a very low base such as the oil shale which Senator Allott was referring to, no matter how high percentage depletion is, you are not going to end up with anything. And so the base has to be looked at.

Mr. SUTHERLAND. Right.

Senator MILLER. Now, I am sure you live with the problem that I referred to a few moments ago.

Mr. SUTHERLAND. Yes, the end product valuation.

Senator MILLER. The end product readily marketable concept. It seems to me that Congress tried to resolve, generally I think with Treasury acquiescence, and that amounted to sort of a compromise that instead of taking Internal Revenue Service's position of this very low base which would have really been extremely costly to your industry, we came up with a higher base. I cannot recall.

Mr. SUTHERLAND. It was what we call the pug mill cutoff which was the end of the grinding but before the manufacturing point started.

Senator MILLER. That is right, but that gave you a higher base, though at the same time it was not as high as perhaps you would have liked to have.

Mr. SUTHERLAND. As the end product.

Senator MILLER. On the other hand, the percentage depletion rate was left alone, was it not, at that time, or was that increased?

Mr. SUTHERLAND. No, that was all a part at the same time of adjustment not only to go back from the end product point down to a start of what the Treasury called the manufacturing process, and also a reduction in the rate.

Senator MILLER. Yes, so that there was a tradeoff. There was a reduction in the rate on the one hand, but there was a very substantial increase over Treasury's position on what the base would be, to which the rate was applied, is that not so? Granted it was not as much as you would like, as your industry would like to have had, but it was a great deal higher than what the Treasury position had been in some of this litigation, is that not so?

Mr. SUTHERLAND. That is true.

Senator MILLER. And so the point I am making is that it seems to me that just a few years ago the Congress tried to resolve this by working out a compromise, a package both with respect to the base against which the rate was to be applied, and the rate itself, and now all of a sudden, just a few years later, under the House-passed bill, the rules of the ball game are supposed to be changed, so that there is a reduction in the percentage depletion rate, is that not so?

Mr. SUTHERLAND. Yes, partially so, but the problem is, of course, that if we are going to talk about cutoff points, the cement industry has a kiln feed cutoff point, and the clay pipe industry has a pug mill cutoff point, which is entirely different from say loading pipe into kilns. We are not talking about a cutoff point here. We are not talking about the cutoff point in either case.

What I am saying is that we are in competition with an industry that gets a 15-percent rate, and we are only getting 7½.

Now, the matter of the compromise was never fully satisfactory to our industry. It was just something that we had to take.

Senator MILLER. I understand that, but the point I am making is that after a compromise was worked out, and I grant you that it was not all that your industry desired, but it was a case of pretty much take-it-or-leave-it.

Mr. SUTHERLAND. Yes.

Senator MILLER. Still with respect to the rate that was settled on, now the House bill comes along and proposes to cut that.

Mr. SUTHERLAND. Yes, sir.

Senator MILLER. And it is compounding the problem that you had a few years ago.

Mr. SUTHERLAND. Yes, exactly so.

Senator MILLER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. SUTHERLAND. Thank you, gentlemen.

(Clark Sutherland's prepared statement follows:)

STATEMENT OF CLARK SUTHERLAND ON BEHALF OF CLAY PIPE INDUSTRY DEPLETION COMMITTEE

SUMMARY

1. The Supreme Court and the Treasury Department have long agreed on the purpose of this wise Congressional tax policy. Thus, the Clay Pipe industry recommends no reduction of its current 7½% depletion allowance.

2. This small industry ($100 million annual sales) plays a vital role in the water pollution control program of the nation. It requires its depletion allowance to assure a continued supply of raw materials and to maintain modernization of its production facilities.

3. Only certain kinds of clay may be used in the successful production of clay sewer pipe. Such clays do not exist everywhere and must be prospected for on a continuing basis. For example, not a single clay pipe plant exists in all of New England. The plants themselves must be located near the deposits, because of the low profit margin in the industry. The history of the industry is replete with plant-closings because of exhaustion or change of quality of the raw materials.

4. Many clay pipe plants are approaching obsolescence. Expansion and modernization are sorely needed, but risk capital is hard to find and would doubtless be less than adequate with a further reduction in the percentage depletion allowance.

5. Limestone and shale (clay), the principal ingredients used in the manufacture of cement, have long enjoyed a 15% depletion allowance while sewer pipe clay has been reduced. Cement pipe is clay pipe's severest competitor. Also, refractory clay purchased for manufacture of sewer pipe, although 15% when mined, becomes 7.5% when used in clay pipe production. We seek an equitable adjustment in our allowance to eliminate these arbitrary competitive disadvantages.

6. Clay used in the manufacture of sewer pipe, supported by IRS Rulings, under earlier law enjoyed a 15% allowance until it was summarily reduced in 1960 to 5%. Its subsequent increase to 7½% in 1966 was merely a return to 50% of its original allowance. It is clearly unfair to reduce again an already reduced percentage on an across-the-board basis, compared to other minerals which have not heretofore suffered any reductions.

7. Clay used in the manufacture of sewer pipe should be included with that clay which is "used or sold for use for purposes dependent on its refractory properties."

STATEMENT

Mr. Chairman: The Clay Pipe Industry Depletion Committee represents nearly ninety percent of the vitrified clay pipe manufacturers in the United States. We take this opportunity to present our views with respect to Section 501(b)(6) of H.R. 13270, the "Tax Reform Act of 1969".

Comments and recommendations

The percentage depletion should be at least maintained at its present rate for the Vitrified Clay Pipe Industry. The Clay Pipe Industry Depletion Committee believes and recommends that there should be no diminution of the incentives for mineral production provided by a wise Congressional policy of 40 years of successful application.

Relative to the nature and purpose of percentage depletion allowance, the Supreme Court, in the Cannelton Sewer Pipe Company Case 364 U.S. 76 (1960) enumerated as follows:

"Mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets. *Anderson* v. *Helvering*, 310 U.S. 404 (1940). In addition, it is based on the belief that its allowance encourages extensive exploration and increasing discoveries of addition minerals to the benefit of the economy and strength of the nation."

The Treasury interpretation outlined in a statement submitted to the U.S. Committee on Ways and Means by David A. Lindsay, Assistant to the Secretary of the U.S. Treasury, on March 5, 1959[1] states:

". . . it is apparent that the percentage depletion allowance was provided by Congress not only to permit recovery of the investment in the wasting asset but also to provide incentives for explanation necessary for replenishment of the wasting asset by the discovery and development of additional deposits."

It would appear that the Supreme Court and the Treasury are in agreement on the nature and basic purpose of percentage depletion. The manufacturers of vitrified clay pipe support these views and hereby submit the following arguments to support our contention that there should be no diminution of the incentives for mineral production in our industry.

The Clay Pipe Industry is a small one, measured against any one of the giant corporations of America. Total sales in 1968 amounted to approximately $100 million (Bureau of Census). But, our industry plays a vital role in the national program to control the pollution besetting our nation's waters by supplying an essential ingredient—long-life sewage facilities. This is particularly true in urban areas, since many cities recommend clay pipe for sanitary sewerage systems. This is a necessary, highly specialized, low-profit industry. Curtailment of the current percentage depletion allowed the manufacturers of clay pipe would cause severe disruption of an industry which provides an indispensable feature in the nation's housing and construction program.

Manufacturing and exploration

Clay sewer pipe must have the necessary strength, chemical resistance, lack of porosity, dimensional control, and other product characteristics to meet the exacting requirements of Federal and ASTM Specifications.

Only a restricted number of clays have the properties and purity to make an acceptable clay sewer pipe. Among the many qualities necessary in the clay mix is sufficient refractoriness so that the pipe does not deform at the high tempeartures necessary to produce vitrification. Many other essential characteristics such as plasticity, and the ability to dry and fire into a salable product all impose restrictions on acceptable clays for sewer pipe manufacture. Contrary to widely-held and erroneous views, such clays are not available just anywhere for the taking. There is not, for example, a single vitrified clay pipe plant extant in all of New England, for the simple reason that this great region possesses insufficient refractory clay deposits.

The importance of proper and adequate raw materials for a clay sewer pipe plant cannot be over-emphasized. Upon the quality and quantity of this supply is based the ability to produce a marketable product at a profit. Upon this factor is based the investment of the plant and equipment costing millions of dollars.

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[1] Page 22 of Hearings before the Committee on Ways and Means, House of Representatives, 86th Congress, 1st Sess., on the legislative proposal of the Treasury Department specifying the treatment processes which shall be considered mining for the purpose of computing percentage depletion in the case of mineral products, March 5, 6, 9, 10 and 11, 1959.

Clay sewer pipe plants are highly specialized but *not* highly profitable operations and are *not* readily convertible to other types of manufacturing.

In order to be sure that this investment is secure, clay sewer pipe companies maintain exploration departments to prospect for new deposits. They are staffed by men skilled in the science of finding clay beds (in many areas a difficult task), in recognizing the potential ceramic properties and in determining the quality and quantity of materials present in the deposits. This determination usually involves core drilling, elaborate and costly sampling procedures and dozens of laboratory tests on a single deposit.

Test samples must be subjected to all of the processes of pipe making. If the laboratory tests and all of the other factors appear favorable, plant runs must be made in several sizes of pipe under standard manufacturing conditions. This is the ultimate criteria. These plant runs may cost more than all the prospecting, drilling and laboratory testing procedures before them, and yet may finally indicate that the use of the deposit is not feasible.

A modern clay sewer pipe plant is a highly specialized manufacturing facility which is inescapably wedded to its clay deposits. The characteristics of its grinding and screening equipment, extrusion equipment and dies, the heat and humidity cycles of its dryers, and the recirculation, burning and cooling methods in its kilns are all based on the characteristics of the raw material upon which it must feed.

If the clay deposit must be changed for another or its ceramic properties change, the resultant costs in adapting the plant's facilities are enormous. When the clay supply is exhausted, the plant has lost its value unless another source can be located where the clay can be obtained at equally low cost. Because of the low profit margin in the industry, it is impracticable to ship clays into the facility at any great distance under normal competitive conditions.

The history of the industry is replete with examples of clay product plants closing because of a lack or a change of their raw materials.

Depletion is an incentive to plant expansion to help meet the health and pollution control needs of the Nation. Many clay pipe plants are approaching obsolescence by today's standards. Expansion and modernization are definitely needed in this era of expanding population but because of the low profit potential it is difficult to obtain risk capital and ploughed back earnings have not always been adequate to meet the needs for expansion in the United States.

In many metropolitan areas in the United States sanitary conditions are deplorable. The Business and Defense Service Administration of the U.S. Department of Commerce, estimates that some 40 million people need new or improved sewage collection systems.

The clay pipe industry is highly essential to the health and welfare of our people. Members of the industry are well aware of the need for new plants to increase production for tomorrow's needs and are moving forward in that direction within their limited financial ability to do so. Continuation of the allowance for percentage depletion under the law as now written will provide our taxpayers with some of the funds which will be needed to finance expansion and modernization and exploration.

Additional recommendation for equitable adjustment

We understand and concur in the difficult efforts of the Committee to revise our income tax laws so that all may share in the burdens fairly. It is in this spirit that we invite the attention of the Committee to the discrimination inherent in the present provisions which authorize for limestone (used in the manufacture of cement) a percentage depletion of 15%, whereas the allowance for clay (used in the manufacture of sewer pipe) is one-half that amount. We do not protest the higher rate; we believe that the availability and cost of recovery of natural resources should be the major factors in the determination of the allowable rate. Nevertheless, we do believe that equity is not served by a double allowance for clay's major competitor (concrete pipe made from cement) producing its product in all 50 states while sewer pipe clay is mined in less than half that number. Furthermore, the Committee should be aware that the shale (clay), which forms another basic ingredient of cement, is also entitled to a current 15% allowance. This fact of tax life adds one more weight to the competitive imbalance which favors clay pipe's competitors.

Under earlier law, refractory and fire clay used in the manufacture of clay pipe was allowed the 15% rate, just as even now refractory clay used in making fire brick is allowed the higher rate. Please refer to Internal Revenue Ruling 56-59 which defined refractory clay and included this sentence: "In this connection, fire clay used to enable sewer pipe to retain its shape and dimensions under extremely high temperatures required for vitrification is considered to be used as refractory fire clay."

Subsequent legislation unfairly and probably inadvertently reduced clay pipe's allowance through failure to recognize the essentiality of refractory clay to the manufacture of clay sewer pipe whereby it had obtained its original standing with refractory clay at 15%. It is also of interest to observe the singular inequity which arises in those instances where clay pipe manufacturers purchase fire clay for use in the manufacture of clap pipe. Although fully entitled to the 15% depletion allowance in the possession of the seller, the rate on this self-same material drops dramatically to 7.5% when put to use in the production of vitrified clay sewer pipe.

We believe the United States Senate Committee on Finance will welcome this opportunity to correct a long-standing inequity by restoring the depletion allowance of clays used in the manufacture of vitrified clay sewer pipe through revision of Sections 501(b)(6) and 501(b)(4)(B) of H.R. 13270 to include in the latter a specific reference to vitrified clay sewer pipe.

The CHAIRMAN. I would like if I may, to ask a few more questions of Mr. John Greenlee. I would like to call him back for that reason. Is he available to us?

STATEMENT OF JOHN R. GREENLEE—Resumed

Mr. GREENLEE. Yes, Mr. Chairman.

The CHAIRMAN. I would like to ask you a little bit about the capital gains royalty. I understand that your group is against that, at least they opposed it when it became law.

Mr. GREENLEE. That is right, sir.

The CHAIRMAN. Here is the thought that occurs to me. If a man has minerals, and he wants to sell them, he is entitled to sell them by any fraction he wants to. He can sell you 1 percent of his minerals, one-third, one-quarter, or one thirty-second. In any event, that is a capital gains transaction. He is selling part of his minerals.

Mr. GREENLEE. Yes, sir.

The CHAIRMAN. Now, it would be similar if he is selling you some of his lands. He can sell you 1 acre or 10 acres out of 100 or he can sell you an undivided interest. In any event, that would be capital gains. But when he is selling his stock investment, whether he is selling a fraction interest or selling it by the share, he still gets capital gains treatment.

Mr. GREENLEE. Yes, sir.

The CHAIRMAN. But when he sells his minerals, if he tries to sell a fraction of a share, he always comes up the loser in that the purchaser will get an estimate which invariably is conservative for good reason. It tends to destroy a geologist's reputation if he estimates that there is more there than there is. If he estimates on the short side his reputation is honored, but any bank that makes the loan or any purchaser who buys, and finds there is not at least as much there as was estimated, he would tend to lose his reputation as a geologist.

Mr. GREENLEE. I quite agree.

The CHAIRMAN. That being the case, he cannot very well sell and be sure that he is going to get paid for everything he is selling unless he does sell by the unit. Therefore, I would wonder why would it be wrong that a property owner should be permitted to sell his minerals or any part of his real estate by the unit rather than selling it as a fractional interest and receive a capital gains treatment in either event?

Mr. GREENLEE. Senator Long, I do not suggest that we feel it is wrong that he be able to do that. We were looking, if you will, sir, at the other side of the coin. The problem that I personally have with this, that if it is a capital gain to the lessor, to the fee owner, it could raise the question as to the right of the operator to deduct the royalty payment. We have a little problem with that side of the question. We wanted to preserve our deduction and we felt there was some difficulty with the capital gain on one side and with the ordinary deduction on the other side. If you will, I think we were quite selfish in our appraisal of this. I do not disagree at all with what you have stated.

The CHAIRMAN. In other words, then as I understand it your opposition was based on the fact that you felt that you ought to be able to deduct?

Mr. GREENLEE. Quite right.

The CHAIRMAN. As an ordinary expense to you?

Mr. GREENLEE. Quite right.

The CHAIRMAN. And if it was a capital gain to the other fellow you felt that you could not very well deduct it as an ordinary expense to you?

Mr. GREENLEE. We felt at least that might raise the question and I think this was the major reason for our position in opposition and not at all on the side of the fee owner as you have suggested, sir.

The CHAIRMAN. So it was not that you quarreled with him about the merits of his position?

Mr. GREENLEE. Right.

The CHAIRMAN. It is just that it gave you a tax problem on the other end?

Mr. GREENLEE. I think you are quite right, yes, sir.

The CHAIRMAN. Thank you very much.

That clears it up for me. That completes this morning's session.

We will meet again tomorrow at 9:30.

(Whereupon, at 12:15 p.m. the Senate Finance Committee recessed, to reconvene at 9:30 a.m., Wednesday, October 1, 1969.)

TAX REFORM ACT OF 1969

WEDNESDAY, OCTOBER 1, 1969

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 9:30 a.m., in room 2221, New Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Anderson, McCarthy, Byrd of Virginia, Williams of Delaware, Bennett, Curtis, Miller, Fannin, and Hansen.

The CHAIRMAN. The hearing will come to order.

Today we will continue receiving testimony with respect to that part of the House tax reform bill which reduces depletion allowance and cuts back on tax advantages of production payments of natural resources.

The subject before us this morning concerns the effects this bill will have on oil and gas.

Our first witness I am pleased to say is the Honorable John G. Tower, distinguished Senator from Texas.

Senator and neighbor, we are proud to have you.

STATEMENT OF HON. JOHN G. TOWER, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator TOWER. Thank you, neighbor, Mr. Chairman. It is a great pleasure to be here this morning and to discuss something that I know is dear to the hearts of both of us.

Mr. Chairman, I have asked to come before this distinguished committee this morning because I am fearful that proposed changes in our tax laws, as set forth in H.R. 13270, will strike a particularly heavy blow to the oil and gas industry of this country, and in turn to our Nation's defense capability.

As a member of the Senate Armed Services Committee, I am well aware of the vital role a healthy oil and gas industry plays in maintaining a strong defense posture.

In Southeast Asia today, for example, one-half of the military effort there is supplied by the United States, with about 65 percent imported from the Arabian Gulf and 25 percent from the Caribbean and other localities.

I believe it is crucial for our Nation's defense that there be maintained in this country the capability to supply our own petroleum needs in case foreign oil resources are denied as they were for a short time during the Middle East crisis of 1967. Even within the past 30 days we have heard threats of boycott from the Arab nations.

Mobilization studies of the Defense Department show that any type of extended emergency involving the United States and its allies could not be adequately fueled by the United States alone. Therefore, reliance must be placed upon other free world sources in the Western Hemisphere such as Canada and the Caribbean area. The target date for any appreciable amount of oil production from the Northern Slope of Alaska is estimated to be 1972, so we cannot depend on that resource at the immediate moment.

Our national security dictates that we have in existence petroleum resources capable of satisfying our needs. Petroleum cannot be stockpiled like hardware. The only way of insuring an adequate domestic petroleum supply is through a healthy domestic oil and gas industry. A healthy oil and gas industry requires continual exploration, continual employment of a labor force and continual access to risk capital.

The Defense mobilization studies to which I just referred indicate that we need a petroleum industry in our own country which is capable of producing even more oil and gas than it is now. I am fearful that if Congress approves the tax changes now proposed for the petroleum industry, it will gravely reduce the industry's production capability precisely at a time when there is need for even greater production.

It is imperative that our domestic oil industry be capable of sustaining this country's requirements under any conditions. This strategic material is one of the items absolutely essential to defense and thus it is foremost in the minds of military commanders. The difference between military success or failure could easily hinge on the availability of enough petroleum products at a given particular time.

In the petroleum industry, production hinges on the availability of capital. The importance of capital to our oil industry and in turn to our defense posture, our national economy and the well-being of all Americans, cannot be overemphasized.

Over 90 percent of all the work done in this country is done by machinery. This machinery is lubricated adn often powered by petroleum products. The use of machinery has contributed heavily to the high wages and high standard of living possible for the people of this country.

The accumulation of capital to finance growth in our business economy has been historically successful in promoting and maintaining our position as the greatest industrial nation in the world.

In order for our private enterprise system to function successfully, it must have a steady and continuous supply of new private capital. One of the world's serious problems today is the shortage of investment capital. In spite of the great benefits our American system has brought us, I fear it is in danger of being severely damaged through an unreasonable system of taxation.

There is a very great difference between capital and income. Our federal tax system is based on income and should remain so. Taxation of capital results in a draining away of that capital and in turn less and less income for all.

As you know, I have firmly advocated the continuation of the 27½-percent depletion allowance for oil. I continue to do so. This allowance, together with the ability to deduct intangible drilling costs and associated exploration expenses from oil and gas income, is the prime source of generating new capital within the oil and gas industry itself. That generation of new capital must be maintained in order to encourage continued health in our petroleum industry and continued overall economic benefits for all Americans.

Today, you will hear excellent testimony of a highly technical nature to substantiate the vital importance of finding and using our domestic oil and gas reserves. Various forms of production payments have been successful in the past as a means of consolidating and transferring newly discovered reserves to skilled oil and gas operators, resulting in greater efficiency in production. I urge you to consider carefully, ways of updating and refining the method of sale and purchase of these unproduced natural resources, not eliminating this avenue of financing.

In summary, I would stress the need for a system of taxation of our oil and gas industry which will encourage continued health within that industry. I urge this because of our Nation's dependency on the industry economically and because of its dependency for an adequate defense operation. I know you are anxious to hear other witnesses who are capable of providing far more expert testimony and so I have tried to keep my remarks brief.

Thank you for your kind attention.

Mr. CHAIRMAN. Thank you very much, Senator.

As you know, we are limiting ourselves to either no questions or only one question verbally. However there may be written questions that you can provide answers to for the record. Thank you very much.

Senator TOWER. I will be glad to provide any answers that I can for the record. Thank you, Mr. Chairman.

Senator HANSEN. Mr. Chairman, before we go further today, may I ask is it your thought that there will be no questions from members of the committee? We will not have even one question to the witnesses?

The CHAIRMAN. What I would suggest would be that we will ask no more than one verbal question of the witnesses until they have all been heard. At that point if you want to call the witness back, Senator, you can call all you want.

Senator HANSEN. I would like to ask one question if I could.

The CHAIRMAN. Go right ahead.

Senator HANSEN. Senator Tower, on the 30th of September our colleague Senator Proxmire testified before this committee, and made this observation:

"The rationale for the depletion allowance is supposedly rooted in national security. Without depletion allowance so the argument goes"—he continued—"we would not explore for the oil which we need in order to protect ourselves from possible interruptions in our oil supply. This myth was destroyed by the CONSAB Committee."

You are a member of the Armed Services Committee and I would like to ask you if you get the feeling from the military that there is not an interrelationship between the depletion allowance and the availability of supplies of oil adequate to assure our national security.

Senator TOWER. Senator Hansen, I think I can attest that the military is vitally concerned. Oil production is not something you can turn on and off. I think some people have the idea that we have got so much in the way of reserves, all we have to do is leave it there, and if we ever need it we just turn the tap and the oil flows. It does not happen that way.

It is a high risk business, and it is difficult to get capital to invest in this kind of high risk venture, unless you provide some tax incentives, and without these incentives, there will be not much in the way of additional petroleum exploration in this country.

Now about 80 percent of our oil reserves in this country were discovered by independent operators, adventurers if you please, gamblers if you please, but people who had the guts to go out and look for oil, knowing that the risks were very great indeed, and if we do not continue these incentives, if we destroy wildcatting, if we destroy the incentive to go out and explore for oil we are not going to have adequate resources to meet our needs if we get into a crisis, and we could very well be in one today or tomorrow that shuts off our source of supply from the Middle East.

The national security will be very gravely jeopardized. If we get into a worldwide conflagration of any kind, we are going to need our domestic resources, because we are not going to be able to transport adequate supplies from other parts of the world.

Senator HANSEN. Thank you, Mr. Chairman.

Senator FANNIN. Mr. Chairman, one question.

Referring back to the copper strike and problems we have had when we have had to go for foreign copper, the price went up about 50 percent. Don't we face the same problem as far as oil is concerned if we start depending on it?

Senator TOWER. Yes, Senator Fannin, we do. The fact of the matter is it has been alleged that by virtue of the fact that we have import quotas, by virtue of the fact we have all these incentives to keep domestic production going, we artificially maintain a high price for petroleum products, including those that come in from the Middle East, but the fact of the matter is if we were without a domestic supply, then we would be really under the gun, and the foreigners who ship oil into this country, the foreign interests, could control our petroleum prices as well. This could be an economic weapon in the world war, for example.

Senator FANNIN. We would be at their mercy?

Senator TOWER. Yes, sir, we certainly would be.

Senator FANNIN. Thank you.

The CHAIRMAN. I think I will ask one question.

Texas produces about half of this Nation's oil?

Senator TOWER. We used to, Mr. Chairman. We do not any more I am afraid.

The CHAIRMAN. We produce about 10 percent in Louisiana. I also claim that we produce more than you do for our size, not comparing my size to yours but comparing Louisiana's size to Texas.

Senator TOWER. Mr. Chairman, my grandfather was born in Red River Parish, La., so I can claim to be a Louisianan here today.

The CHAIRMAN. Senator, isn't it true that even the present incentives have not been sufficient to make this country self sufficient in this basic resource? We now import about 25 percent of our needs. I am told that with regard to your west Texas wells, there are only about six or seven oilfields in Texas that could really increase their production by as much as 25 percent if the Nation's demand required it and if the nearest oil was shut off and denied to us, and we could not get oil in from Venezuela.

Most of these little upland fields have been depleted to the point that they could not be expanded by any 25 percent.

Senator TOWER. This is true, Mr. Chairman. You would have to go to a very expensive process of secondary recovery which I think would be uneconomical by present standards.

Now if you want to put yourself in a position of paying an extremely high price for domestic production, you could get some additional oil out of the ground, but the fact of the matter is why take that route when indeed we know that there are additional sources available to us in this country if we can just go find them, and we need to maintain the incentives to go find them.

The CHAIRMAN. Thank you very much, Senator.

Senator TOWER. Thank you, Mr. Chairman.

The CHAIRMAN. The next witness is the Honorable Dewey F. Bartlett, Governor of the State of Oklahoma, and I think the Senator from Oklahoma will want to introduce the witness.

Senator HARRIS. Thank you very much, Mr. Chairman. I just want to say that I ask the committee to hear at this time from Oklahoma's Governor, Dewey Bartlett, because I knew that he would be a strong voice for the concern which our State feels about the detrimental impact that this bill and the Treasury recommendations would have on the oil and gas industry which are so important particularly in our own State.

Governor Bartlett and I served as members of the Oklahoma State Senate together. From his own background, his activities as a member of the Interstate Oil Compact Commission and his present position as Governor of our State, we feel that he is an excellent spokesman on this issue, and I am proud to welcome him here.

STATEMENT OF HON. DEWEY F. BARTLETT, GOVERNOR OF THE STATE OF OKLAHOMA

Governor BARTLETT. Thank you, Senator Harris.

Mr. Chairman and members of the Finance Committee of the U.S. Senate, I wish to discuss certain provisions of the so-called tax reform measure now before you as it affects the basic economic or the State of Oklahoma.

The oil industry, aside from agriculture, is the largest industry in Oklahoma. We live in an economy that is largely tied to the well-being of this industry. Our cities, towns, and school districts have largely been developed as oil has been developed.

Since 1956 we have seen in Oklahoma a consistent decline in the number of wildcat wells drilled, producing wells completed, crude reserves available for future demand, and the number of people directly employed in the industry. However, more than 51,500 people in Oklahoma are directly engaged in the exploration for oil for drilling, developing and production and the processing of crude oil.

The annual direct payrolls of these employees exceeds $400 million. These wage earners provide the direct livelihood for over 200,000 of our population and the indirect livelihood for almost an equal number. Our cities and towns are dependent upon the maintenance of this employment.

Many of our school districts are almost wholly dependent upon the nearby presence of an oilfield, a pipeline terminal or a refinery for survival.

We have approximately 3,600 oil operators in Oklahoma producing oil and/or gas from 72 of our 77 counties. Many of them are small independent operators, dependent upon stripper wells for their livelihood. A stripper well is one that averages 10 barrels a day or less, making it a marginal operation from the profit standpoint.

The latest published figures showed there were 56,893 stripper wells in Oklahoma. Nationally there were 376,000 such marginal wells. The average daily production of an Oklahoma stripper well is 4.28 barrels per day. The independent historically has been the finder of new oil. He has been able to take the chance to drill the wildcats, to seek new fields and pools.

He has developed a successful business within the existing tax structure, and by his ingenuity many millions of barrels of oil have been discovered that have strengthened and supported the Nation both in peace and in war.

The effect of this bill is to increase sharply the taxes on those engaged in the production of petroleum. The major oil company will be faced with two alternatives. One, reducing his exploratory drilling and research activity and keeping expenses at a minimum and, two, to increase costs of the refined products such as gasoline.

Undoubtedly the large company will do both. It will result in the added costs being passed on to the consumer and the price of oil and expense to the integrated company being held as low as possible.

On the other hand, the price of crude oil represents the principal source and often the only source of revenue to the average independent. He is not in a position to pass on his increased expense. Therefore the independent operators will further decrease in number and will no longer be a viable segment of the oil industry.

Oklahoma derives 29 percent of its tax revenues from the petroleum industry, in addition to the economic taxes paid by the many companies and their employees. This is also exclusive of the ad valorem taxes paid to the counties and school districts on pipelines, pump stations, refineries, and other properties.

Oklahoma is in the midst of a tremendous economic development effort. In 1966 the capital expenditure for the manufacturing industry was $50 million. Last year this figure was $155 million, and through the first 8 months of this year it has already reached $174 million.

The gains in manufacturing would be offset by a significant decline in the oil industry. Obviously a decline in oil activity will sharply reduce revenues to the State of Oklahoma, revenues on which we are dependent.

This is another point that I think has not been made enough, Mr. Chairman and members of the committee. That in addition the State will pay directly a part of the increased taxes to the oil companies. This is because Oklahoma is one of the 12 States permitting Federal taxes paid as a deduction on State income taxes due.

When Federal income taxes are increased, Oklahoma suffers a decline in revenue. Eleven other States will likewise suffer, and this includes the States of Louisiana, Arizona, Montana, and a total of 12.

I have touched briefly on the effect that the bill will have on the States in general, the small businessman and the consumer. Finally I must warn you of the dangers hidden in this bill to the national security and the national resources of this country. If we shut down the stripper wells, many of which can never be reopened, we have wasted a great national resource by abandoning it beneath the surface.

If we dry up our source of discovery, the independent, we will never find millions of barrels which is tantamount to wasting the same resources.

When this happens, and it has already started happening from the pressure of other costs, the United States will become more dependent on foreign oil. I know no Member of this Congress will gamble on our country's future.

On the municipal bond features of this bill I concur in the excellent presentation made by Gov. John Love of Colorado and the other five Governors that appeared before this committee previously. The proposed method of handling this matter is ill-advised and unnecessary, and if an evil exists, that should be checked. It can easily be done by placing a limit on the amount of tax-exempt income one may have in relation to total income.

In conclusion, the true measures that should be applied to the existing law as it relates to the petroleum industry, aside from the element of national defense, preservation of our reserves, our oil reserves, are the availability of petroleum products at reasonable prices, the profitability of the industry as compared to other domestic industries, the ability of the industry to keep down prices, and whether the oil industry is paying its fair share of taxes.

If the oil industry is not paying its fair share of taxes, this committee should provide the pertinent facts.

We enjoy a lower price for petroleum products than any other free nation. The price of gasoline at the wholesale level is now one-third less than it was during World War I. The U.S. wholesale price in

1918 was 23 cents. In 1966 it was 15.89, the last year figures are available.

It has 50 percent more power than the 1918 product.

Over a period of 43 years, the oil industry has received a lower return on net worth than all manufacturing industry according to the First National City Bank monthly economic letter. Obviously tax burdens placed on the oil industry will be passed on to the consuming public. The independent operator will be unable to offset his increased burden. Exploration will dry up. Many stripper wells will be shut down hurting primarily the independent operator. His activity will be increased sharply.

Our dependence upon foreign oil will be increased and every little man that buys a gallon of gasoline will pay part of the bill. For Oklahoma to maintain its present level of services, this proposed legislation will require the Oklahoma taxpayer to be further burdened with a significant tax increase.

The CHAIRMAN. Thank you very much.

Governor BARTLETT. Thank you, Mr. Chairman.

Senator HANSEN. Mr. Chairman, may I ask a question?

Governor Bartlett, your testimony sounds very much as though you might have been testifying for Wyoming. In our State I think a third of all of the county taxes are paid by the petroleum industry. We have an equal dependence as does Oklahoma upon this industry. I would like to ask you if this tax bill as presently before us should be passed, would it affect significantly the employment rate of people in your State?

Governor BARTLETT. Yes, sir. Our employment rate would decline very sharply. There is just no question about this. The revenues to the State would also decline. It would be necessary to have a tax increase to provide the same level of services.

Senator HANSEN. Thank you, Mr. Chairman.

Senator MILLER. Mr. Chairman.

Governor Bartlett, you stated that the oil industry is paying its fair share of taxes. I presume you were referring primarily to Oklahoma, with which you are most familiar. Can you give us an idea of how much in State and local taxes the petroleum industry pays in your State?

Governor BARTLETT. I believe the gross production tax figure for the latest, for the last year, I believ ewas $45 million. This of course is a large part of the moneys available to the State. The total paid for on the income tax, I do not have that figure, bnt they pay, I think my testimony shows, 29 percent.

Senator MILLER. 29 percent?

Governor BARTLETT. Yes.

Senator MILLER. Of what?

Governor BARTLETT. Oklahoma derives 29 percent of its tax revenues from the petroleum industry.

Senator MILLER. And by that do you mean either from the income tax or from——

Governor BARTLETT. This is all sources.

Senator MILLER (continuing). All sources?

Governor BARTLETT. Yes.

Senator MILLER. That is the State?

Governor BARTLETT. Yes.

Senator MILLER. What about local taxes?

Governor BARTLETT. This is in addition to the ad valorem taxes, and of course they would pay ad valorem taxes throughout the State.

Senator MILLER. Do you have any idea of how much that amounts to?

Governor BARTLETT. No, sir; I do not.

Senator MILLER. Would it be difficult to find out and furnish it for the record?

Governor BARTLETT. I will make every effort to furnish that. I know it will be very significant.

Senator MILLER. I think it might be helpful for us to find out the total tax package outside of the Federal income taxes that the industry is paying to the State and local governments in your State.

Governor BARTLETT. Senator Miller, I will furnish you with that information.

Senator MILLER. Thank you, Governor.

(The information to be furnished for the record had not been received at the time of printing.)

The CHAIRMAN. Governor, since that point came up, many people contend that the industry is entitled to no credit for carrying a very heavy excise tax on its product. You mentioned that the wholesale price of gasoline today is 15.8 cents. The retailer usually has a markup of about 6 cents. That would make it 21.8, and the product carries an excise tax of about 10 cents a gallon State and local.

Now, the overall tax burden that industry carries is roughly $8 billion. It is the most heavily taxed industry in America. Percentagewise whisky carries more. It cost about 90 cents to manufacture a gallon of whisky and it carries $9 in Federal taxes, so you buy a bottle of whisky, you are buying 90 percent taxes and 10 percent alcohol.

Senator HARRIS. That is not quite the same as 90 proof.

The CHAIRMAN. Maybe that is what they mean when they say 90 proof. But people say that the industry passes the taxes on to the consumer. Well, every industry has to pass the taxes on to the consumer if it is going to stay in business. If it does not pass the taxes on in the price of a product, it would have to go out of business. It goes broke. Capital leaves that industry and invests it in something else.

Do you know of any other industry paying $8 billion a year in taxes to Government?

Governor BARTLETT. No, sir; Mr. Chairman, I do not. I think another thing that is not often thought of in the oil industry, it is a very competitive industry with many independents, many people competing with major oil companies, many large companies. The independent cannot pass on his extra costs, the extra taxes, that would be a result of the lowering of the depletion allowances.

He cannot do that because he does not set the price on crude oil as you well know, and so he is going to either go out of business, reduce his operations, reduce the reserves available to this Nation, reduce his activity, or go into some other business.

So the independent is faced with a very questionable future.

The larger company also the same. He is burdened with more expensive exploration costs in Alaska and offshore, where the independent is not so active, and without the depletion allowance which has worked so well for a long time, he would be operating in a very questionable area costwise and would have to pass this on to the consumer.

The CHAIRMAN. Thank you very much, Governor Bartlett.

Governor BARTLETT. Thank you, sir.

The CHAIRMAN. The next witness will be Mr. Emilio G. Collado, executive vice president, Standard Oil of New Jersey. Down Louisiana way he is better known as "Pete."

Is Mr. Collado here?

Mr. Robert DUNLOP. If we may take a moment of privilege, we were going to present a panel at this point in time, Mr. Chairman.

The CHAIRMAN. Senator Scott, the newly elected minority leader of the Senate, would like to introduce Mr. Dunlop, president of the Sun Oil Co.

STATEMENT OF HON. HUGH SCOTT, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SCOTT. If I may, Mr. Chairman, I have another committee meeting.

Would you come up, please, Mr. Dunlop. I believe as Mr. Dunlop said, he would like the privilege of introducing the whole panel including the witness whose name you mentioned.

It is a privilege for me, Mr. Chairman, members of the committee, to introduce Mr. Robert G. Dunlop, president of the Sun Oil Co., who is an old friend, and who when named to this post was one of the youngest executives in the oil industry and one of the most knowledgeable.

I am very proud to have known him, to have been his friend all these years. I imagine that a number of the members of the panel have heard Mr. Dunlop before, and he will indicate to you other representatives of the industry who wish to be heard.

I am most appreciative of the courtesy and of this opportunity. If it were not a matter of deference to the time of the committee and the witnesses, I would go on further, but it is a great privilege and I am glad to have this opportunity.

COORDINATED TESTIMONY OF THE AMERICAN PETROLEUM INSTITUTE: MID-CONTINENT OIL & GAS ASSOCIATION; ROCKY MOUNTAIN OIL & GAS ASSOCIATION; AND WESTERN OIL & GAS ASSOCIATION; PRESENTED BY ROBERT G. DUNLOP, PRESIDENT, SUN OIL CO.; WILLIAM I. SPENCER, EXECUTIVE VICE PRESIDENT, FIRST NATIONAL CITY BANK; GEORGE V. MYERS, EXECUTIVE VICE PRESIDENT, STANDARD OIL CO. OF INDIANA; AND EMILIO G. COLLADO, EXECUTIVE VICE PRESIDENT, STANDARD OIL CO. OF NEW JERSEY

Mr. DUNLOP. May we call our associates, please, Mr. Chairman.

Mr. Spencer, Mr. Myers, and Mr. Collado.

The CHAIRMAN. Mr. Dunlop, I am in your debt whether you know it or not. Your company found some oil in Louisiana and I have sued your company and was successful and I appreciate it.

Mr. DUNLOP. That is correct.

Senator BENNETT. Mr. Chairman, before this group of witnesses starts to testify, and in view of the fact that the whole day practically is going to be spent hearing witnesses representing the oil industry, I would like to suggest that each of them who may have an important point of view to suggest to the committee take a minute to talk to us about the potential effect of the Alaska discovery on the situation that we face. I think that would be very helpful.

The CHAIRMAN. I think that is fine, but, Senator Bennett, I do not see any particular point in somebody discussing Alaskan oil if he does not have some of it. Now Standard Oil of New Jersey has some of it. Does the Sun Oil have some of that discovery?

Mr. DUNLOP. We are not that fortunate, Senator.

The CHAIRMAN. How about the other two companies? One speaks for the First National City Bank. I imagine you are financing some of it. Does Standard Oil of Indiana have some of it?

Mr. MYERS. We are sure optimistic about finding some.

Senator BENNETT. Not necessarily now but I think at some time during the discussion.

Mr. COLLADO. I am Emilio G. Collado, executive vice president of the Standard Oil Co. of New Jersey. I would be happy to answer your question, Senator Bennett.

It is true that our affiliate, Humble, is in partnership with Atlantic Richfield in the Prudhoe area in the north slope of Alaska, and we and the British Petroleum Co. had the initial discovery in that field.

We have been making a number of projections both for other committees of the Senate and for the oil import study. As you know, the President has established an oil import task force under Secretary Schultz, and our people have submitted a number of projections of what we think of the prospects of north Alaska into the public record.

If you wish, we can bring out some of that material here now. I happen to have it in another case over here.

(The material referred to appears on p. 4428 of the record.)

Something like this is what is involved. The present oil reserves of the United States are about 31 billion barrels. These are the booked reserves at the end of last year. We would anticipate that between now and 1985, there will be additional bookings of reserves on something of the order of 72 billion additional barrels, if the existing economic environment of the industry is continued, by that I mean the present tax structure, and an import policy perhaps somewhat modified from the present, but basically of the same order of impact as the present import policies.

Under those circumstances, we estimate that 31 billion barrels will be found in the north slope of Alaska, about 20 billion barrels in the deep offshore including up to depths of perhaps 2,000 feet, and then perhaps something just under another 20 billion barrels—these are reserve figures, billions—for the land areas of the 48 States. That adds up to approximately the 72 I am talking about.

These are very important reserves in Alaska. We think that the Prudhoe Bay structure, which is the one area that has definitely been found, may have not less than 10 billion barrels. Some other companies have estimated reserves of 10 to 12 billion barrels, but all the public announcements are generally compatible.

We think this discovery is important. It is the largest field ever found in North America. On the other hand, when you start comparing it with reserves in the Middle East, when you start comparing the production that can come from it, with the very vast increases in our domestic requirements, it is important and we are happy to have found this oil, but it does not begin to answer all the problems. I think there has been a great misconception, that somehow our adventuresome transportation experiments and the fact of this oil have revolutionized things. It is important but it is not decisive.

We figure that in the 1970's the production that can be removed from Prudhoe Bay to the United States will be of the order of 1½ to 2 million barrels a day. We are consuming now 14 or 15 million barrels a day. We expect that consumption to go up to 19 million barrels a day by the end of this period, so it is important, but it is not all that big, Senator.

The CHAIRMAN. You think we have 30 billion barrels of oil in reserves within the United States including Alaska right now, I take it?

Mr. COLLADO. Including Alaska, but no bookings yet for the Prudhoe Bay. That is before the Prudhoe Bay. It includes the booked reserves of southern Alaska which are relatively minor.

The CHAIRMAN. All right. Now, how long would that last this country at present rates of production?

Mr. COLLADO. It is only about something like 9 years at the rate that we are producing it.

The CHAIRMAN. So we have found enough——

Mr. COLLADO. And on top of that we are also importing some from other countries, but it is about a 9-year production rate in the United States.

The CHAIRMAN. So if we were cut off from foreign oil, we have enough to last us for about 9 years, unless we find more.

Mr. COLLADO. That is correct, Senator. The only problem is that you cannot actually produce it that quickly. There is an ultimate recovery of 31 billion barrels but you do not necessarily get it in 9 years, because of the problem of maximum economic recovery which prevents you from taking the entire amount of oil out in those 9 years. You would lose a lot of oil if you tried to take it out that quickly.

The CHAIRMAN. If you tried to produce it all in 9 years——

Mr. COLLADO. You would not get it.

The CHAIRMAN. You would leave an awful lot of oil in the ground.

Mr. COLLADO. Yes, also the facilities are not there to take it out. The water and gas drives and other things are just not all in place to get it out that quickly.

Senator MILLER. Mr. Chairman, could I ask a question at this point?

There are two facets to this question, Mr. Collado. No. 1, can you tell us approximately how much has been spent by the petroleum industry or by any segment of it in making the find in Alaska, and second, can you tell us how much more would be spent between now and 1985 in order to achieve the 31-billion-barrel resources that you referred to?

Mr. COLLADO. Well, I am afraid I cannot give you anything like precise answers to the first part of your question, and I am afraid I cannot even give you imprecise answers to the second part.

I believe that the industry has indicated in various surveys that have been made that the total expenditures of the whole industry, in all parts of Alaska, to date are on the order of $1.9 billion. A good deal of that was in quite unrewarding efforts in parts of Alaska that so far have not become economic for most companies.

As to the future, we have been quite careful not to talk about what we expect our ultimate costs will be, because these things are still so uncertain. We feel that to get the oil out of Prudhoe Bay will require a great deal of expenditure in field facilities through water flooding and that sort of thing.

The chairman of Humble, who is an old expert in producing matters, which I am afraid I am not Senator, told the task force working on the import policy the other day that until a field has been produced at least 5 percent, you really cannot be very precise as to what the ultimate recovery of the field will be nor what the costs of recovery will be.

Now there has not been anything taken out of this field yet. We are just beginning.

I think it is safe to say that the costs of recovery on the Prudhoe field will be several times the figures that have been publicly mentioned by some academic and other interests that have been writing on the subject.

In addition to that, the costs of transportation to get it out of the northern part of Alaska will be enormous. A group of companies has announced a $900 million pipeline project across Alaska, and that would only bring the oil to the southern part of Alaska.

At the rate of escalation which we may expect in costs, plus the very complicated problems of building a pipeline there, plus the additional problems of not disturbing the ecology, which as you know has been the subject of a great deal of discussion in Alaska just in the last few months, I think that $900 million is at best a low estimate of what it will cost.

We are spending something on the order of $39 million on our experiment with the tanker *Manhattan*, which I am sure you have read about, and I think it is now indicated that it is possible to get up there.

Whether it is possible to get up there 12 months a year is not completely settled by the existing experiments, nor is it clear how much it will cost to design tankers of a proper shape. These are very expensive—$50 to $60 million for each tanker. These costs are going to be tremendous, and we have not added them all up.

Other projects which are still in the talking stage are whether you build a fleet of tankers to come down from southern Alaska to the Pacific coast, and then a pipeline into the central part of the United States and possibly all the way to the east coast, or whether you build a pipeline starting up in Alaska and going through northern Canada and down.

There are any number of possibilities here. These things all run into billions of dollars. Every item we talk about runs billions of dollars. I cannot answer you any more precisely today.

Senator MILLER. Thank you very much.

The CHAIRMAN. Proceed.

Mr. DUNLOP. Mr. Chairman and members of the Finance Committee, I am Robert G. Dunlop, president of the Sun Oil Co., Philadelphia, Pa., I am accompanied by Mr. William Spencer of the First National City Bank, Mr. George V. Myers of Standard Oil Co. of Indiana, and Mr. Emilio G. Collado of the Standard Oil Co., New Jersey. Our appearance today is in behalf of the American Petroleum Institute, Mid-Continent Oil & Gas Association, Rocky Mountain Oil & Gas Association, and Western Oil & Gas Association.

In the next 10 years the United States will consume 60 billion barrels of liquid petroleum and 225 trillion cubic feet of gas. Everything we say today must be considered in the context of the challenge this poses for our industry. I hope to indicate why it is vital to the Nation's security that the domestic industry provide the bulk of that petroleum. I will also discuss the present condition of the industry, and the likely impact of proposed tax changes on the industry's ability to fulfill present and future petroleum needs.

It is not an overstatement to say that petroleum is the lifeblood of our Nation. Oil and gas supply nearly three-fourths of all energy consumed in this country. The Department of Defense has asserted that oil is one of the few strategic materials that is absolutely essential.

The policy of the Congress has been to provide the incentives necessary to assure the continuance of a strong domestic industry, capable of meeting the essential oil and gas needs of the Nation. Today this policy is being questioned.

The basic decision we now face is the choice between:

1. Maintaining a strong domestic petroleum industry, or
2. Relying to a greater extent on less secure imported petroleum.

This decision should be based on a careful consideration of two questions.

First, are the tax incentives effective in achieving an adequate domestic petroleum supply?

Second, is an adequate domestic supply still essential to our national interest?

I should like to affirm that these tax incentives have been successful.

At the end of World War II, productive capacity was barely equal to demand. We had no reserve capacity. From this low point the tax incentives, together with the thrust of rising prices during the late 1940's, enabled the industry to improve steadily the supply situation.

As a result, since the early 1950's we have had significant reserve-producing capacity. In 1968 this capacity amounted to 3 million barrels daily.

We have met the current needs of this Nation, and have also helped to meet the emergency needs of friendly nations on three occasions since World War II when their supplies of petroleum were interrupted. I submit that without sufficient petroleum supplies in the United States, during and since World War II, the course of history might indeed have been different.

Tax incentives have played a key role in enabling the industry to provide adequate supplies of energy at reasonable prices to the American people. In addition, the depletion provision has provided important technological and economic contributions to the Nation's welfare. Technological advances have enabled the industry to produce economically oil and gas previously impossible to recover. Improved drilling capabilities have permitted the industry to recover oil and gas at depths that were formerly impossible to drill. Secondary recovery techniques have doubled the amount of oil we can recover. I want to emphasize that percentage depletion is a particularly effective incentive for technological improvement in exploration and recovery since it is based on production.

Existing petroleum tax policies have contributed positively to our balance of payments and have played a major role in the economic progress of developing nations.

Tax incentives have likewise made a contribution to the conservation of natural resources by encouraging the production of marginal oil rather than abandoning this oil.

It is often asserted that petroleum tax incentives result in excessive profits, and that the industry does not pay a fair share of taxes. The facts are that the industry's profits have been less than average, and the industry has paid more than its share of taxes overall.

With respect to profits, petroleum producing and refining companies in 1968 earned a return of 12.9 percent on net assets compared with an average of 13.1 percent for all manufacturing companies. In 8 of the past 10 years the average rate of return for manufacturing companies was higher than for petroleum companies. Profits in our industry are not excessive.

With respect to taxes, direct taxes exclusive of motor fuel and excise taxes paid by the petroleum industry in 1966, the last year for which the complete figures are available, were 6 percent of industry revenues. This was more than 5.8 percent of revenues paid by mining and manufacturing companies, and the 4.8 percent of revenues paid by all business coporations. The petroleum industry is carrying more than its fair share of the tax burden, even though its Federal income taxes are reduced by the depletion provision.

The real beneficiaries of percentage depletion have been the American consumers, who have had an ample supply of energy at reasonable prices. The wholesale price index for crude oil has risen just 5 percent from the 1957–59 base, while the index for all commodities has increased by 13 percent. The price of gasoline excluding excise taxes has advanced approximately 10 percent since the 1957–59 base period, while consumer prices generally were up some 28 percent.

Now, I would like to turn to the problem of national security, placing this matter in a current context. What would be the situation tomorrow if Israel and the Arab countries were to fight on a full-scale basis?

If this should occur, access to Arab-bloc oil would undoubtedly be severely restricted. This would be critical, because the Arab-bloc countries control overall 71 percent of the Free World's oil reserves outside the United States and Canada.

It is my judgment under these circumstances that Canada and the United States would share available spare capacity. Today the two countries have sufficient capacity to cover their imports from Arab nations plus some additional reserve to help Europe and Japan. However, if the United States did not have a large domestic petroleum industry, our military security and economic strength would be crippled.

A Middle East conflagration is not a remote possibility, but rather a situation which we might have to face up to at any time as events of recent years have clearly indicated. Therefore it is imperative that we maintain a viable domestic producing industry.

A reduction in the depletion allowance would either result in higher product prices or an increased dependence on less secure foreign crude. Neither alternative is desirable.

Higher prices for gasoline and heating oil, for example, would fall more heavily on the Nation's lower income groups since they spend a much larger proportion of their income on such necessities.

If prices do not increase, the reduced depletion allowance would result in reduced investment in domestic exploration and development, and increased reliance on foreign oil.

Reduced investment is clearly undesirable at a time when we have been unable to expand domestic reserves in step with our growing domestic requirements. Both oil and gas reserves declined last year and the gas supply situation has been called critical by a member of the Federal Power Commission. Overall, even with the new Alaskan discoveries, the industry will have difficulty in providing for our expanding petroleum needs.

In accepting this alternative we would be assuming a long-run risk that cannot be measured in monetary terms. We could be drawn into a conflict in the Middle East, in an attempt to insure stability. A substantially increased U.S. role in the Middle East could well lead to a direct confrontation between the two nuclear superpowers.

In conclusion, it is my considered judgment that the tax incentives granted the petroleum industry are effective, and that an adequate domestic petroleum supply is a critical need for the security of the United States.

In the national interests, gentlemen, I urge you to maintain existing tax incentives at their present level.

Thank you very much for your kind invitation.

Mr. Spencer will now make the next presentation.

Senator HANSEN. Mr. Chairman, if I may interrupt for just a moment, in order to understand what the situation will be, I do gather from what you have said earlier we will be permitted to ask one question of each of these witnesses. When would you like us to do that?

The CHAIRMAN. Any time you want.

Senator HANSEN. If I may, since Mr. Dunlop has just testified, I would like to ask do I conclude correctly from what you have said that continued domestic exploration is absolutely essential to assure the safety and well-being of this Nation?

Mr. DUNLOP. Yes, sir, Senator Hansen. I do not think there is any question about that. We anticipate that in the 1970's we will have a consumption of some 60 billion barrels of liquid petroleum, and 225 trillion cubic feet of gas, and as Mr. Collado indicated a few moments ago. we have a reserve position currently of somewhat better than 30 billion barrels, not including the Alaskan North Slope reserves. This means that the industry in this period of time, the 1970's, is going to have to discover and develop something in the neighborhood of 50 to 60 billion barrels. In order to discover reserves of that magnitude, I feel it is very important that these tax incentives be maintained, because the discovery of these reserves will provide the assurance that we will be able in that area of interest to preserve our national security.

Senator HANSEN. Thank you, Mr. Chairman.

Senator FANNIN. Mr. Chairman.

Mr. Dunlop, you certainly brought out the importance of exploration and what is involved in our Nation depending upon the petroleum reserves. You say that nearly three-fourths of all energy consumed in this country comes from oil and gas.

Now, as I understand it, there are many products involved, and a sufficiency in one product does not necessarily mean that there is a sufficiency in others. You mentioned the liquefied petroleum products, 60 billion barrels I think you mentioned.

Mr. DUNLOP. This would be crude oil and what we call natural gas liquids, the liquids as distinguished from——

Senator FANNIN. Propane and butane?

Mr. DUNLOP. Propane and butane would be in that category, liquefied petroleum, yes, sir.

Senator FANNIN. Then you are going into other products as I understand it, bottling ethane and methane?

Mr. DUNLOP. Well, these other lower hydrocarbon fractions, are used in the energy market, but over and beyond that, of course they are one of the significant supplies of petrochemicals.

Senator FANNIN. What I am alarmed about is that here we are talking about using natural gas to propel motor vehicles when we have a tremendous shortage of natural gas, and even this year we may have trouble in some areas of our country. Now that will not be alleviated by our production in Alaska, so we will need to have greater exploration in this country, in order to take care of that need; is that correct?

Mr. DUNLOP. Senator, that is very true. Just one comment on the use of some of these lighter fractions in the internal combustion engine. That is generally the area of propane. There has been a move in that direction more recently.

The real concern with respect to natural gas is the fact that last year in the United States we consumed something on the order of 19 trillion cubic feet of gas. Our additions to reserves were only in the neighborhood of 13.5 trillions, so we only found about 70 percent of the natural gas, that was consumed, and our concern in that regard, of course, relates to an increasingly expanding market, and the ability of the industry to discover the natural gas that will take care of these needs.

Senator FANNIN. Yes. That is what I understand.

Mr. DUNLOP. You do emphasize a very significant factor.

Senator FANNIN. It is one of the very critical needs as far as our exploration in this country.

Mr. DUNLOP. Yes, sir.

Senator FANNIN. Thank you.

Senator HARRIS. Mr. Chairman. Perhaps one of the other witnesses can get to this. If so, all right, but that is particularly what Senator Fannin raised I wanted to raise.

You mentioned that the oil and gas reserves have declined. I am particularly interested in the gas end of that, the natural gas end of that. What is demand doing and what do you expect it to do with regard to natural gas?

Mr. DUNLOP. Well, actually there are two factors in the natural gas situation. The natural gas situation, of course, enjoys these tax incentives the same as liquid petroleum. However, you have the further factor with regard to natural gas that the well-head price of gas is controlled by the Federal Power Commission. Frankly, it would be my feeling that that over certainly the last decade or 15 years the price of gas has been inadequate to induce the amount of investment that would have been required to develop gas reserves. I think this is another very critical aspect of this problem, Senator Harris, that not only do you need the incentives that are inherent in the tax system, but it is my opinion the industry also needs a more reasonable price at the wellhead in order to go out and search and discover gas.

In your own State we recently drilled a gas well which was successful. It cost somewhat in excess of $4½ million. We found gas, but there is a real question in our mind at the present price levels as to whether or not we would be justified in continuing a development program in that area.

I just would like to say this. We believe there is an awful lot of gas yet to be found, but you need not only the incentives which the Congress has wisely provided in the tax legislation, but we also believe that we need more adequate prices, Senator.

The CHAIRMAN. May I ask if this is about the size of it. If you consider all taxes rather than just one tax, consider all taxes, State, local. Federal, excise as well as income—this industry is paying more taxes or at least it is carrying a heavier tax burden than any industry in America. It is making less profits after taxes than the average for manufacturing companies. To provide the Nation with its fuel requirements in the next 10 years, it must find twice as much oil as it has found or presently has on hand in recoverable reserves. To do all this the industry needs enormous amounts of capital, both to find oil. refine it and move it around.

These heavy capital requirements presuppose sufficient profits to attract the capital into the industry. At the present time the profits in the industry are not as good as the average for manufacturing. Isn't that about the problem?

Mr. DUNLOP. You have stated it extremely well, Mr. Chairman. In fact, Mr. Spencer, our next panelist, will direct his attention to this problem in some detail.

Senator HARRIS. That is his problem to find you some money to do all of this stuff with.

Mr. DUNLOP. That is very true.

Senator MILLER. Mr. Dunlop, I am referring to pages 70 and 71 of the committee print of the various testimonies for today, and I believe this relates to pages 20 and 21 of your testimony, at least in my printed copy. I want to raise a question about the point you make regarding oil imports.

On page 20 of your statement, I find the statement that "Elimination of the import control program * * * would result in an 85 percent drop in the volume of exploratory drilling."

Mr. DUNLOP. Yes, sir.

Senator MILLER. And then on the next page I find a reference to projections made by the Department of Interior predicting that upwards of 58 percent, using a pessimistic approach, upwards of 58 percent dependency on foreign oil by 1980 if oil import controls were eliminated.

Now on the one hand I see an 85 percent drop in exploratory drilling estimated. On the other hand, I see a dependency of upwards of 58 percent on foreign imports. Can you give us the interrelationship between these percentages, or is there any interrelationship?

Mr. DUNLOP. Yes, Senator: I believe there is. In the first instance in the testimony that I supplied or in the detail statement, I indicated that in the replies to the questionnaires that were submitted to the Cabinet Task Force on Oil Import Control, it was stated that if there was a reduction in revenues of approximately one-third, there would be an 85 percent reduction in the exploratory effort. As a consequence of that reduction, we would have the result indicated on page 21 of my longer statement, namely that going into the 1970's you would then be in a position as a Nation to have to depend on foreign sources of oil for better than 50 percent of our total requirement.

Senator MILLER. When you refer to a drop of one-third in revenues, what were you referring to?

Mr. DUNLOP. Well, a drop of approximately one-third in revenues would be the drop in revenues as a result of a change in the import control, and the allusion that I was making there was that a similar drop in available funds as a result of an impairment of the tax incentives, primarily the statutory depletion allowance, would have a similar effect.

I might suggest, Senator, Mr. Myers is going to deal with that question a little more specifically in terms of varying percentages that may shed some light on that.

Senator MILLER. Thank you very much.

The CHAIRMAN. Proceed.

Mr. SPENCER. I am William I. Spencer, executive vice president of First National City Bank, New York. For many years, I was directly associated with the petroleum and mineral activities of our bank. I, therefore, feel honored to appear at these important hearings, and to discuss with you a few of the basic problems presented by some of the proposals now being examined by this committee.

I shall confine my remarks to two broad areas. In the first place, I shall briefly discuss the importance of petroleum in strengthening the U.S. position in international trade and payments. Second, I shall urge you to consider most carefully the industry's capital needs.

On the first point, let me make it clear that I have no doubt of the advantages to the United States of a growing flow of international trade and payments. I have just returned from a visit to Africa where I was struck by the extent to which American people, American capital, and American ideas are now working to enhance our image and increase our income in the most remote places. To forget the interdependence of the United States and its trading partners abroad would be a little like trying to run Manhattan without the tunnels and bridges connecting the island to the mainland.

Our bank has often expressed concern over the policy of restricting capital outflows by the system of controls introduced early in 1965. Similar objections would apply to tax changes likely to interfere with earnings from direct investments abroad. Over the years, petroleum investments abroad have shown their ability to earn a return on book value appreciably better than that of other investments abroad. The net effect of the foreign investment activity of the petroleum industry has been an inflow of funds of nearly $1 billion annually. Most of the capital now required to support this inflow is not drawn from sources in the United States, but from earnings made and reinvested abroad, and from sums raised from investors abroad.

Now, gentlemen, I should like to turn to the capital outlook. The reason investors have in the past been willing to risk their money in this business is, of course, that they were anticipating an adequate return on their money. Tax incentives played an important role in attracting investors to this industry. At the same time, the industry's profits have not been excessive, as Mr. Dunlop has demonstrated.

There seems to be an impression, expressed during the hearings early in September, that these tax incentives are expendable. I support the case for sharing the tax burden as equitably as possible. As the President himself has pointed out, taxes can be made fair—but not popular. Reducing the mineral tax incentives, as now under discussion by this committee, might be popular today. But will it be popular 10 years from now? In the long run, because of the danger of an energy shortage, I do not think it would be wise or fair. In fact, during the 1970's, tax incentives for mineral production will be even more essential than during the 1960's.

I am not saying that the tax system should be left unchanged. But any tax system should meet the tests of being simple, stable, and in tune with long-term economic needs. Insofar as the mineral provisions are concerned, I do not find that the proposed measures meet any of these tests. The proposals now before the committee appear to make the system even more complex. They appear to undermine the stability so vital to productive investment. And they conflict with long-term needs by adding a bias in favor of consumption and unfavorable to investment at a time when the Nation is struggling to rein in an inflation that threatens to run away.

My concern with regard to the tax proposals extends across the whole range of minerals. Coal, uranium, copper, and other basic resources will be essential to our economy in the future even more than they have been in the past. Oil shale will one day come into its own as a major source of the Nation's energy. But, in the rest of what I say, I shall be focusing on oil and gas.

Looking at the petroleum industry from a banker's viewpoint, I see no reason for overconfidence that this country can successfully cope with the petroleum demands of the 1970's. I see no justification for a crackdown on the petroleum industry. Instead, I think the industry will need all the cooperation it can get from this Nation. Let me tell you why.

As a banker, I am uneasy about the petroleum industry's capital outlook—how much capital it will require and how much it can obtain. I see all too little basis for the confidence that was expressed by administration spokesmen before this committee concerning the adequacy of the capital supply.

In the first place, there is the shortage of capital in the economy as a whole. With the big corporations—and even the Federal Government—having to pay 8 percent or more on recent bond and note issues, the present stringency is clear for all to see. Nor do we expect any early relief. In a recent 5-year forecast, we came up with the prospect of a sharp increase in the need for both short- and long-term borrowing by leading U.S. industries. For petroleum, we expect to see a drastic increase in the use of outside funds, with the total of short-term borrowing likely to double by 1974.

This trend has already set in. Over the past 10 years, the call for outside financing has obliged the five largest U.S. oil companies to step up the long-term debt component in their total capitalization. Their long-term debt has risen sharply—from about 9 percent of the total in 1958, to over 17 percent last year. There comes a point beyond which even the strongest company cannot continue to depend on borrowing to finance its expansion plans.

In the second place, the needs of the energy sector as a whole are bound to mount rapidly. The expected demand for energy in 1980 represents some 45 million barrels a day of crude oil equivalent. Some 42 percent of it will come from oil—including a small contribution from synthetic fuels, such as shale oil. Over 25 percent will come from gas.

In order to meet this demand for oil, we estimate that gross additions to proved reserves required during the 1970's will total 55 billion barrels—57 percent more than during the 1960's. Continuation of additions at the rate of the 1960's would leave the country 20 billion barrels short of oil by 1980.

For the sake of illustration, let us assume that capital expenditures will increase by the same 57 percent as the necessary additions to petroleum liquid reserves. This yardstick indicates that the industry may require at least $70 billion for domestic exploration and development expenditures alone over the 10-year period 1970 to 1980—an annual average of $7 billion per year in comparison with $4.5 billion annually during the past decade.

Now I should like you to ponder over whether the petroleum industry will be able to attract this stepped-up inflow of capital during the 1970's.

As I have just demonstrated, there are certainly not enough reserves, already known and proved in the ground, to get the industry through the 1970's. Similarly, there is no excess cash within the industry.

What is the petroleum industry's profit outlook for the future? An adequate answer to this question requires, as one most important condition, a clearer view than we now possess of the tax prospect. I shall not try to go into the detail of the tax bill prepared in the House of Representatives. But I must frankly confess that I am struck by the negative emphasis in some of the proposals now being considered by this committee.

Petroleum industry profits emerge as a main target of these various tax proposals. If the Congress adopts part or all of this package. an investor must expect to earn less from his petroleum ventures.

To sum up, a reduction in established tax incentives could reduce petroleum industry profitability to something well below that of other industries, thereby endangering the future capital supply. This could have serious—and insufficiently understood—long-term consequences for our balance of payments, our economic stability, and the welfare of the Nation as a whole.

Thank you, Mr. Chairman.

Senator HANSEN. Mr. Chairman. Mr. Spencer, you speak of the shortage of capital in the U.S. economy to day. You take note of the fact that interest rates are now 8 percent, and that is low as far as I can find out. You call attention to the short-term borrowings that will be doubled by 1974. You also point out that the five largest international oil companies' long-term debt component was around $2 billion in 1959 and that today it is around $5 billion. I would like to ask if you feel that the oil industry will be able to raise the capital necessary to provide the 6 million barrels of oil per day that will be required by 1980, in order to satisfy the needs of our economy, if these proposals made by H.R. 13270 and the Treasury proposals were to be enacted?

Mr. SPENCER. Senator, I think that the industry will have a very difficult time providing the total energy needs of a burgeoning economy with present incentives. We heard Mr. Collado talk about the capital requirements to develop and exploit what appears to be a major reserve on the North Slope. I think under any circumstances, with the industry earning at less than the national average, there will be great problems.

Certainly, if the ability of the industry to earn profits is materially affected, it will in a compounding way increase the difficulty.

Senator HANSEN. Thank you.

Senator FANNIN. Mr. Chairman.

Mr. Spencer, you emphasize the heavy overseas expenditures by the oil companies. Then you also talked about the balance of payments, that a favorable balance of payments would result. Could you just review that?

In other words, you are making heavy expenditures but still the balance of payments is favorable according to your testimony?

Mr. SPENCER. Over the past years, being an aggressive industry, the oil companies were early in the business of looking for reserves overseas. As in all phases of the industry, this does require substantial amounts of money.

However, in recent years, when our international balance of payments has become critical, the oil industry, by virtue of repatriations of capital over and above expenditures, have on a net basis contributed $1 billion annually to a plus balance of payments.

Senator FANNIN. Thank you very much.

Senator ANDERSON. You paint a pretty gloomy picture. Some people made some bids in Alaska not long ago. What was the size of those bids—$900 million?

Mr. SPENCER. It was in the neighborhood of $1 billion; yes, sir.

Senator ANDERSON. Wasn't that pretty large? Were they all fools?

Mr. SPENCER. We think not.

Senator ANDERSON. Why do you——

Mr. SPENCER. Could I suggest they have some confidence in the lawmakers of the country who have enabled them to produce energy. They have defined a major new source of energy and they have some hope that the ground rules will not be changed so they will be shot down in midair.

The CHAIRMAN. Might I just ask about the other side of that question. As far as just drilling the ordinary wildcat well is concerned, it is my understanding that people do not just pay bonuses for ordinary wildcat prospects any more.

Mr. SPENCER. That is right.

Senator ANDERSON. They want you to pay them something to drill and see if there is oil down there.

Mr. SPENCER. That is right.

Senator ANDERSON. As a practical matter it used to be that somebody would pay you $10, $20, $30 an acre as a bonus to drill a well. Nowadays my impression is for the ordinary upland prospect, there is no bonus. If they want to drill it people just practically volunteer the land. Bonuses are not paid any more.

Mr. SPENCER. I believe that is correct.

Senator ANDERSON. Of course what you are talking about in Alaska is where somebody went and found some fantastic field up there and somebody next door to it will pay for that. They paid $900 million. They can't be complete fools about it.

The CHAIRMAN. How deep is the oil sand in that Prudhoe Bay field?

Mr. COLLADO. I am not sure that I can really get into this.

The CHAIRMAN. Just an offhand guess.

Mr. COLLADO. How deep?

The CHAIRMAN. How thick is the oil sand in Prudhoe Bay?

Mr. COLLADO. How thick?

The CHAIRMAN. Yes; how thick is the producing sand?

Mr. COLLADO. The producing sand runs several hundred feet.

The CHAIRMAN. All right. If you find 5 feet of oil sand down my way you think you are lucky.

Mr. COLLADO. Could I add one thing, Senator, although I was not asked the question. I do not think that if we had had the circumstances that Mr. Dunlop referred to in answering a question from Senator Hansen, that is if one-third price decline took place, whether from a change in the import policy or a comparable complete elimination of tax benefits, there would not have been any bids in Alaska, because a company could not possibly afford to go to Alaska on that basis.

I did want to add one thing to my previous answer to Senator Miller concerning reserves in Alaska. The 31 billion barrel eventual reserve by 1985 is entirely contingent on opening up both the naval reserve and the wildlife refuge which present other problems. Without those areas the central part of the north slope we could not possibly arrive at any such large reserve figures.

The CHAIRMAN. Proceed.

Senator MILLER. May I ask a question?

Can you give us two figures. No. 1, an estimate, for example, for 1968 of the total amount of percentage depletion allowance of the petroleum industry or such segment thereof as you might be familiar with. And the second figure would be the total amount of 1968 exploration, drilling, development, and other activity.

Mr. SPENCER. I do not have those figures here, but I think I can get some pretty close numbers which I will be glad to supply later.

Senator MILLER. Am I correct, maybe you can answer at this time, am I correct in my feeling that the amount of expenditure on exploration, research, and developing drilling by the industry is substantially in excess of the amount of the percentage depletion allowance?

Mr. SPENCER. That is correct, sir.

Mr. DUNLOP. Senator Miller, I think maybe we can contribute some numbers. The statutory depletion provisions is somewhere between $2½ and $3 billion, and the effort expended by the industry resulted in an expenditure of some $4.5 billion, in the magnitude of those figures, but as Mr. Spencer says, we will be glad to supply precise figures to the extent they are available.

Senator MILLER. Thank you.

(The information to be furnished for inclusion in the record at this point follows:)

SUN OIL CO.,
Philadelphia, Pa., October 2, 1969.

Hon. JACK MILLER,
U.S. Senate,
Washington, D.C.

DEAR SENATOR MILLER: At the hearing before the Senate Finance Committee on October 1, I was asked how much the Petroleum Industry had deducted in depletion and how much it had spent on exploration and development. I agreed to furnish the Committee that information.

The Industry's estimated depletion deduction was 2.4 billion in 1966 and 2.6 billion in 1967. The Industry spent 4.9 billion in exploration and development in 1966, and 5.3 billion in 1967. Thus, these expenditures have been almost twice as much as its depletion deductions. These are the most recent figures available.

I appreciate the opportunity to appear before your distinguished Committee to express my views. If I can be of further assistance to you in your important deliberations on tax reform legislation, please do not hesitate to so advise me.

Sincerely yours,

ROBERT G. DUNLOP, *President.*

The CHAIRMAN. Proceed.

Mr. MYERS. I am George V. Myers, a director and executive vice president of the Standard Oil Co. of Indiana.

I will discuss the risks inherent in exploring for petroleum. Then I will comment briefly on the provisions of H.R. 13270, and other proposals affecting oil and gas producers.

Unique risks accompany the search for oil and gas. Despite technological progress there is but one sure way to know whether there is oil and gas in a particular place in the ground and that is to drill a hole. Only about 11 percent—one out of nine—of the wildcat wells drilled during the period 1953 to 1967 were producers. In 1968 the rate dropped to 8.5 percent—one out of 12.

However, many of the wells that find oil or gas do not find enough to be profitable. The million barrel finds are where success begins. Here the average is about 2 percent—one well out of 50.

Furthermore, past averages may well mean little in the coming years. Costs increase as we drill deeper and explore in the more remote areas.

The CHAIRMAN. May I just interrupt you. I regret that one of my colleagues is not here. He disputed that figure when I said only one wildcat well out of 43 was a good well. Now, you are saying it is actually less than that. It is about one in 50 that is considered a good find.

Mr. MYERS. That is right, Mr. Chairman, and as I further said, there is some doubt about some of those one in 50 being profitable. Well, you know if you find a field offshore in Louisiana that has a million barrels of oil, you cannot afford to build a $2 million platform to produce it.

Senator ANDERSON. Why do they do it then?

The CHAIRMAN. They don't.

Senator ANDERSON. They do, of course they do.

Mr. MYERS. They walk away.

The CHAIRMAN. The point is that if you have to build a $2 million platform to store the oil and produce it, even though there is $1 million worth of oil down there, the smart thing to do is put cement in that hole and walk off and leave it.

Mr. MYERS. All I am really saying is that many of the wells that are in the million barrel category are now becoming in the same uneconomic posture as some of the little finds that are in the one out of nine.

Confronted with the task that lies ahead, the industry needs more incentives. Now, is hardly the time to cut our depletion rate, to eliminate production payments, and to increase the individual producer's taxes by requiring him to allocate his deductions.

These proposals, in conjunction with the extension of the surtax, the repeal of the 7-percent investment credit, and the capital gains tax changes would siphon a tremendous amount of cash out of an industry already pressed by the need for more capital.

The curtailment of existing tax incentives would restrict future exploration and development expenditures. Our best estimates indicate that reducing the depletion rate from 27½ to 20 percent would reduce exploration expenditures by at least a fifth. Such a reduction would make our Nation become unduly dependent on foreign petroleum with all of the attendant risks and dangers pointed out by Mr. Dunlop. We have been accused of scare tactics when we counsel caution. But bear in mind, petroleum is our business, and we would not be meeting our responsibility if we failed to inform the Nation of the hazards that we foresee.

Under Secretary Walker has observed that the proposed changes affecting tax-exempt securities have made investors in that market "skittish." He thought the psychological impact on the market was out of all proportion to the proposed change. Investors in State and local bonds were afraid "of the rug being pulled out from under them later." We believe the reduction in depletion would engender the same fear among oil and gas producers. They, too, would be apprehensive about further reductions.

As a consequence, expenditures for exploration and development could very well decrease considerably more than the one-fifth I have mentioned.

The percentage depletion deduction was designed to recover the capital value of oil in the ground. At today's price of crude, the deduction provided by the full 27½ percent falls short of the value of reserves as measured by the sales price of proven properties.

Billions of dollars have been invested in the oil business, in reliance on present tax incentives. For example, the industry has paid $3 billion to the Federal and State Governments for mineral leases in the waters of the Gulf of Mexico. It has spent in addition more than twice that amount in exploration and development of that offshore area during the past 23 years.

Senator Fulbright called the increase in the income tax burden of investors in outstanding tax exempt securities a "breach of faith." I feel that reducing the depletion rate on existing oil and gas properties is a similar "breach of faith."

Let me say a few words about some of the other provisions of H.R. 13270.

The CHAIRMAN. Senator Anderson has a question.

Senator ANDERSON. You say it is a breach of faith. Senator Williams has been pushing this reduction for years and years and years. If the Congress decided to accept it why would it be a breach of faith? I cannot understand your term.

Mr. MYERS. I will define the term, sir. The bulk of the billions of dollars that have been invested in the oil business over the past years have been made in the expectation that the then existing tax incentives would continue.

Senator WILLIAMS. When was your company organized?

Mr. MYERS. It was more than 75 years.

Senator WILLIAMS. Seventy-five years ago. When was the depletion allowance started first?

Mr. MYERS. My recollection is that the first special provision for depletion was probably 1918. It was retroactive to 1913, when the income tax was first imposed.

Senator WILLIAMS. Was that a breach of faith when the Congress gave it to you?

Mr. MYERS. By no means, sir.

Senator WILLIAMS. By the same token Congress can take away that which is given to you if they see fit, can they not?

Mr. MYERS. That is right.

Senator WILLIAMS. I fail to see that there would be any breach of faith on the fact that we consider changing the tax structure any more than there would be if we change the corporate rate or any other tax. I realize you have got a great industry and I respect you and I respect your right to come in and argue for it. But like the Senator from New Mexico I do not think it is any breach of faith. I do not think you have any inherent right or constitutional right for this tax break forever. There is nothing sacred in the 27½ percent. It could be increased or lowered as Congress sees fit.

The CHAIRMAN. If I understand it, Mr. Myers, you made an analogy. You mentioned that Senator Fulbright said that when people bought tax exempt State and local bonds, they were relying upon the fact that those bonds were not going to be taxed by the Federal Government, and that it would be a breach of faith to tax them when they were sold on the basis that they were not going to be taxed. That is what Senator Fulbright said and you drew an analogy.

You said you had a $27\frac{1}{2}$-percent depletion allowance to encourage you to go out and provide this Nation with its fuel requirements, and having invested billions of dollars relying upon that law, it would be a breach of faith after you put your money into it then to change the law on you and deny you the incentive that you had when you went out to find the oil.

Now, are you aware of the fact that in this same bill we are proposing to take away the investment tax credit and we are proposing to let every company have 10 years to get that equipment delivered if they had signed the contract for the equipment?

Mr. MYERS. I am aware of that, Mr. Chairman.

The CHAIRMAN. Doesn't that indicate that we sort of believe in keeping the faith when we gave somebody an investment tax credit—that we are not going to take it away, irrespective of an existing contract?

Mr. MYERS. Which is certainly equitable.

The CHAIRMAN. All I am saying is that I think your analogy is correct. You were given this incentive to go out and do something. You did what you were encouraged to do and having spent many billions of dollars somebody wants to change the law on you before you get your money back. It would seem to me that the analogy is correct.

Mr. MYERS. Senator Williams, I would just like to add one comment, and I think that this is merely emphasizing something that Mr. Collado said a few moments ago concerning the importance of new discoveries in Alaska. I am sure that those of us that went up there and spent many millions of dollars on leases, and probably his company, when it went up there and drilled a discovery well, would not have spent those millions of dollars had not we felt that the present tax incentives would be continued.

Now, we may have been completely foolish, but having adopted this attitude, I think that there is some justification in my use of the term "breach of faith."

Senator WILLIAMS. The point is that just as we change the investment tax credit we can change the depletion allowance. At the time you were getting the investment tax credit, we were proposing to repeal it. At the time the leases were purchased the House had already taken action to reduce the depletion allowance. So you knew that it was at least being seriously considered, and as you admitted when your company was first organized there was no depletion allowance.

Now, I just do not think there is anything sacred about the $27\frac{1}{2}$ percent depletion allowance. When the first depletion allowance was started it was around 14 percent. Later $27\frac{1}{2}$ percent depletion allowance was considered as a necessary contributing factor to orderly exploration. Times change.

Now the question in the minds of some of us is whether the petroleum industry is paying its fair share of the cost of operating our $100 to $200 billion Government. It is a debatable point. There are two sides to the question. I appreciate the arguments that can be made against it, but I do not like to think we should have to accept the approach that there is a locked-in advantage for the industry. Nor do I think that it would be a breach of faith if some of us are successful in our arguments that it should be somewhat modified. I think that we can argue it on its merits.

The CHAIRMAN. It would not be any breach of faith for Senator Williams to do it. He has been voting against depletion allowance since the day he came here.

Mr. MYERS. Thank you, Senator, for giving me the opportunity to elaborate a little on why I feel as I do about this. I certainly respect your viewpoint.

Shall I go ahead?

Senator ANDERSON. I raised the question because I think I have been a pretty consistent voter on the depletion allowance. But I do not think you should accuse the Congress of a breach of faith when it is just doing what it has the right to do. We hear in newspaper stories about a breach of faith. And you are right here stating it. I do not think it is so at all. We vote with the finest of motives. It may be wrong but it is honestly not a breach of faith at all.

The CHAIRMAN. It would be a breach of faith if I did because I ran for office saying I wasn't going to vote that way, so it just depends I think on the conscience of each Senator. That is just about the size of it.

Mr. MYERS. Senator Anderson, just one more comment on this subject. I believe there is a differentiation between investments that were made in the past in reliance on incentives and investments that are made in the future. If we want to go ahead and make these risky investments in the future after Congress has acted to take some incentives away from us, I think then we perhaps are being foolish. I think there is a strong distinction here between past investments and what we do in the future.

Senator ANDERSON. I think that is so also. I merely do not like your term "breach of failth" when you vote your own convictions. I know Senator Byrd had some questions about voting at one time——

Mr. MYERS. Sir, if you find the words very offensive I apologize for having used them, but I feel compelled to express my own conviction.

The CHAIRMAN. I think the record is amply clear on this point. You might get on with the rest of it now.

Mr. MYERS. All right, sir.

Let me say a few words about some of the other provisions of H.R. 13270. The treatment of production payments as loans puts another squeeze on the industry's capital, particularly on the independent. It will cause a 15- to 20-percent reduction in the value of producing properties, thereby restricting their use in obtaining the financing necessary to continue the search for new petroleum reserves.

Another drain, through the back door this time, on an individual operator's capital is the provision that would require him to allocate his itemized deductions solely because he claims legitimate business deductions for depletion and intangibles.

The only bright spot we find in the natural resource provisions of H.R. 13270 is the treatment of shale oil. The bill not only keeps the 15-percent rate for shale oil, but also clarifies existing law by correctly classifying the retorting of shale oil as a mining process. I urge the committee to accept the House bill provisions relating to shale oil.

Before discussing the Treasury proposals, let me say that the technical memorandum of the Treasury position became available only yesterday. Consequently our analysis has been based on the Treasury's testimony. We may want to submit detailed comments on the technical memorandum after we have had an opportunity to analyze it thoroughly.

There are two Treasury proposals that ought to be rejected. One would add percentage depletion and intangibles to the limit on tax preference. The other would tax the gains on sales of mineral properties as ordinary income to the extent of intangible drilling costs previously deducted in some cases.

The idea of limiting the deduction for tax preferences at first seems to have some appeal, but after closer consideration, we have concluded the basic concept of LTP is unsound. It hurts most those individuals who respond best to the tax incentives.

Last January there was a lot of publicity about the 154 wealthy individuals who paid no income taxes. Three months later the Treasury Department disclosed that the deduction for percentage depletion amounted to less than 1 percent of the deductions which resulted in their paying no tax.

The proposal to tax gains on sales of properties as ordinary income tax in certain instances could be even more damaging to property values than is the proposal to treat production payments as loans. The combination of eliminating production payments and also imposing ordinary tax rates on gains from property sales would apply an overkill technique which could create almost impossible obstacles to sales of mineral properties.

In summary, the oil business is extremely risky. Tax incentives designed to attract taxpayers to assume those risks have worked well. Proposals to reduce those incentives, if enacted, will encourage present and future investment. This would be most unfortunate. An error in judgment at this time would take years to correct, if indeed it could be corrected at all. We are living in an era of technological progress in a nation thoroughly committed to it. Yet the continuing prosperity that technology promises will be no stronger than our future supplies of oil.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Collado?

Mr. COLLADO. Thank you.

I am Emilio G. Collado, a director and executive vice president of the Standard Oil Co. of New Jersey. We strongly urge that sections 431, 432, and 501(a) of the House bill, applying to the foreign activities of U.S. petroleum companies, be rejected.

First, we believe the provisions would harm our country's national security interest in providing ready access to growing foreign sources of oil. If existing domestic tax incentives and import policy are continued we expect that annual additions to oil reserves in the United States will be greater in the future than in the recent past. Notwithstanding this prospect, our country in years ahead will have to rely increasingly on foreign source oil, Canadian and overseas, to meet our growing economic and military needs. The best way to provide for availability of sufficient foreign source oil is to encourage U.S. companies to continue to search for and develop these resources in diverse foreign areas.

The foreign investments of U.S. petroleum companies are also an important source of strength to our balance of payments. Experts outside the oil industry have estimated that a dollar invested in the petroleum industry abroad is fully returned in the balance of payments in 3 to 5 years, and results in substantial additional contributions to U.S. receipts for many years thereafter. Last year these investments contributed income plus royalties and fees from abroad amounting to about $2.5 billion. Moreover, these investments have enhanced our economic welfare and promoted substantial economic progress in the developing countries.

The ability of U.S. companies——

The CHAIRMAN. Could I ask a question at that point? Is that $2.5 billion over and above what you are investing overseas?

Mr. COLLADO. No; the $ 2.5 billion is the income from the investments plus royalties and fees.

The CHAIRMAN. How much did you take over there during the same year?

Mr. COLLADO. Oh, probably $1 billion-plus. The net for the industry, income less capital flow, was about $1 billion.

The CHAIRMAN. So your industry brought home to this country about $1 billion more than it took out?

Mr. COLLADO. That is right. The oil industry has about 30 percent of U.S. foreign direct investment, and we bring home about 44 or 45 percent of all the income from the foreign direct investments of the United States.

The ability of U.S. companies to compete successfully against foreign oil companies would be seriously impaired by the provisions that we urge be rejected. Many foreign oil companies receive substantial incentives, and in some cases, cash subsidies for oil exploration, as noted in the attachments submitted with my written statement. An increasing number of Government-owned or controlled companies are also competing aggressively on the basis of various special advantages.

It would be unfortunate if our Government took actions which would tip the scales in favor of our foreign competitors. By burdening U.S. companies with higher tax costs in all phases of the industry, sections 431, 432, and 501(a) would sharply restrict the contribution which American oil companies could make to our national security and to these other important U.S. goals. Significantly the greatest impact is likely to be felt in the process of bidding for concession rights in new producing areas.

Finally, enactment of these provisions would violate accepted principles of tax equity and of preventing international double taxation. Section 501(a) would eliminate percentage depletion on foreign oil and gas production alone, thereby discriminating against foreign petroleum operations. Assistant Secretary of the Treasury Cohen pointed out that enactment of section 501(a) would do nothing more than penalize U.S. companies, since foreign countries would be encouraged to increase their taxes on the petroleum industry in order to absorb any additional tax revenue that would otherwise go to the United States. We are glad to see that the Treasury has recommended rejection of this provision.

For companies which have elected the per country basis for applying the foreign tax credit, section 431 would not always allow full credit for foreign income taxes paid up to the amount of U.S. taxes otherwise due on such income. In so doing, this provision would introduce new discrimination against foreign source income, and in some circumstances would result in double taxation of foreign income.

In attempts to justify section 431, it has been argued that present law provides a double tax benefit. The first occurs when companies incurring foreign losses are able to reduce their U.S. taxable income in that year by the amount of these losses. The reasonableness and appropriateness of the ability under present law to combine profits and losses in the United States and abroad is accepted. The second so-called benefit, which is the one questioned, is said to occur when operations turn profitable in the country in which the losses occurred, and the taxpayer is then allowed credit for the foreign taxes he actually paid on such income. Far from being a double tax benefit, the credit for foreign income taxes paid is essential to avoid the inequitable situation in which the taxpayer's foreign income would be taxed twice. I believe the examples in the statement which I have submitted to this committee amply demonstrate the inequities and discrimination against foreign income which section 431 would create.

The Treasury's detailed recommendations released yesterday would mitigate some of these problems, but in some cases would aggravate them. In any event, the provisions would in effect partially deny existing deductions for intangible drilling costs, and thus would further impede U.S. companies in their efforts to participate fully in the growth of the oil industry abroad.

Section 432 would deny to the mineral industry alone the effective use of the overall basis for applying the foreign tax credit. It has been suggested that this provision is warranted because income taxes paid by American oil companies in some foreign producing companies may contain hidden royalties. However, royalties on petroleum production abroad are generally as high as and in some cases considerably higher than royalties paid on production in the United States. After further examination of the hidden royalty question, the Treasury has recommended that section 432 be rejected because it would unfairly discriminate against the mineral industry. In its stead the Treasury has proposed, along with the reinstatement of foreign depletion, that excess foreign tax credits arising from U.S. percentage depletion not be available to be applied against other income. This substitute proposal should be studied further.

The integrated nature of the international oil industry makes it particularly appropriate for U.S. companies to use the overall basis for applying the foreign tax credit, thereby averaging together the high and the low rates of tax paid on operations in all foreign areas. U.S. companies could not economically justify the large investments they make in foreign oil producing capacity without making substantial further investments in refineries, pipelines, tankers and other distribution facilities required to serve the foreign markets for this production. To attempt to separate production activities ignores such economic integration, and contradicts the intent of Congress in introducing the overall foreign tax credit limitation. Moreover, by seeking out individual parts of a taxpayer's income in low-tax countries, and increasing the tax to the U.S. level, section 432 would discriminate against foreign source income and would effectively introduce double taxation on the integrated petroleum industry operations abroad.

I would like to add that we believe that the Treasury's recent recommendation concerning the Continental Shelf, while a step in the right direction, can be improved, and we will submit suggestions on this subject.

(Pursuant to the above discussion the witness supplied the following memorandum:)

CLARIFICATION OF THE U.S. INCOME TAX STATUS OF THE CONTINENTAL SHELF

In testimony before the Senate Finance Committee and in its technical submission of September 30, 1969, Treasury recommended that U.S. income tax status of the Continental Shelf areas of the world be clarified by amending the definition of "United States" in the Code to include the Continental Shelf of the United States with respect to the exploration for naural resources and defining the term "foreign country" as used in the Code to include the Continental Shelf which pertains to the foreign country concerned. While we recognize the need for clarification of the law in this area, we think that the proposal set forth is consistent with the position taken by taxpayers and the Internal Revenue Service in past administration of the U.S. income tax law. Accordingly, we think that any legislation enacted on this subject should make it clear that it is declaratory of existing law and should not provide a basis for permitting either taxpayers or the Internal Revenue Service to take a different position with respect to taxable years prior to the enactment of the provisions.

In connection with the proposed definition of the term "foreign country" we think that it is important to define the term so that it includes any part of the Continental Shelf adjacent to a foreign country with respect to which that foreign country exercises jurisdiction to grant licenses or permits to conduct operations. We think it is important that the definition of the term "foreign country" not be limited to just that portion of the Continental Shelf with respect to which the country exercises tax jurisdiction. Because of its license granting authority a foreign country may attach conditions to the license number which cause the licensee to be subject to the payment of income taxes to the foreign country even though that foreign country may not exercise income tax jurisdiction per se with respect to the portion of the Continental Shelf for which the license is granted and from which the licensee derives income from the production of natural resources. Unless a definition such as we propose is used, a taxpayer carrying on operations on the Continental Shelf of a foreign country which exercises jurisdiction with respect to that Continental Shelf might be subjected to international double taxation if the U.S. income tax definition of the term "foreign country" were not broad enough to include the area in which the taxpayer carried on operations.

It is believed that the foregoing modification of the Treasury Department recommendation is consistent with the position of the National Petroleum Council with respect to the policy which the U.S. should follow regarding the area of the Continental Shelf over which the United States should exercise jurisdiction.

Mr. COLLADO. While I have concentrated on the role of U.S. companies in the industry abroad, those appearing with me have emphasized the need to maintain current tax incentives to the domestic industry, if our country's essential security needs are to continue to be met largely from U.S. sources.

I will skip my summing up for the panel and simply conclude, Mr. Chairman, if I may by saying that each of us has raised questions about the economic impact and the equity of the proposed changes in the tax laws. However, we urge above all that the various proposals be assessed in the light of our country's national security interests.

Thank you.

The CHAIRMAN. Mr. Collado, would you mind telling me in general terms with regard to your overseas operations what is your volume of sales in terms of dollars, how much taxes did you pay on it, how much did you bring home in dividends, and how much taxes are paid on that?

Mr. COLLADO. I have the figures in mind for our overall operation. I can try and submit the foreign domestic. I can give you that in more detail later.

I am speaking now for Standard Oil Co. (New Jersey). There are industry figures, but I can speak more freely about my own figures, since I know them better. We are not completely typical but no company is completely typical.

Our total sales worldwide are about $16 billion. This is to outsiders, third parties.

The CHAIRMAN. Outside this country you mean?

Mr. COLLADO. No, this is the whole world.

The CHAIRMAN. Outside the company?

Mr. COLLADO. Outside the company.

The CHAIRMAN. Yes.

Mr. COLLADO. We have a lot of intercompany transactions. I am talking primarily about the consolidated affiliates, the companies in which we have more than a 50-percent interest. There are some others but we would get into too many technicalities to describe them, so I will not bore you with it. I would say that of those sales something in excess of half are outside the United States.

Our total costs from purchases of supplies, oil from others, salaries for our employees, and payments to outside contractors for various services and other work which we contract out, is something on the order of $9 billion. We booked in taxes in the United States and abroad in 1968 production taxes, import duties, State taxes, local taxes, severance taxes, Federal taxes, and foreign income taxes and royalties just under $6 billion.

The CHAIRMAN. Are you including excise taxes?

Mr. COLLADO. I am including everything, $5 billion plus, which makes it a fairly substantial part of the total.

The CHAIRMAN. Six or five?

Mr. COLLADO. It was about 5.6 last year. This figure goes up at the rate of $400 to $500 million a year, because our tax payments unfortunately go up at a much faster rate than our net income. The result of this, after taking depreciation and other normal offsets—our depreciation runs to perhaps half of our capital expenditures, which now are on the order of about $2 billion a year at home and abroad—is that our income last year after all taxes was $1.277 billion.

In arriving at that number, our liabilities to foreign governments in income taxes were just under $800 million, which was slightly in excess of 50 percent of our income abroad before income tax. We booked on our accounts for the U.S. taxes on the order of $200 million plus, which was about 30 percent of our strictly domestic income.

Our average income tax booking was about 45 percent. Total worldwide earnings before income tax were split about two-thirds foreign and one-third at home, and the net came down as I say.

After booking those taxes we had $1.277 billion. We brought home from abroad something in excess of $800 million. We made profits at home. We did quite a little reinvestment. We paid dividends of about $800 million to largely American shareholders, although there is a certain small proportion of foreign shareholders among them. We estimate our foreign shareholders are less than 5 percent, although we do not have exact figures, because much foreign-owned stock is held in the names of banking firms. We had almost $500 million of retained earnings that went to make up that half of our capital expenditures that we did not finance out of depreciation funds, and we borrowed about half a billion dollars, a quarter of a billion dollars in a debenture issue last year in the United States and something of the same order in various foreign countries.

We are one of those companies that Mr. Spencer said had to borrow very heavily to keep going. It was easier when the rates of interest were lower.

Of the $800 million that went to the shareholders, I suppose according to Treasury estimates close to half of it, at least 40 percent of it, was recouped by the Federal Treasury in income tax payments. Thus we did $16 billion worth of business in order to give the shareholders something less than a half billion dollars' worth of net income.

The CHAIRMAN. How much did you say you paid in taxes, all taxes on sales?

Mr. COLLADO. $5.6 billion I think the figure is.

The CHAIRMAN. All right, so——

Mr. COLLADO. Income taxes were a bit over $1 billion.

The CHAIRMAN. If you had to borrow $500 million, that means to stay competitive and to stay modern you were not able to plow back in enough money and still pay a fair dividend to your stockholders to expand?

Mr. COLLADO. That is right.

The CHAIRMAN. And by the time you got through you were able to pay out $800 million in dividends. After all taxes paid, the people who own the company, the shareholders, succeeded in earning $800 million after taxes on $16 billion in sales, is that about the size of it?

Mr. COLLADO. That is about right; yes.

The CHAIRMAN. So you might say out of every $40 you managed, of sales, you managed to get $2 to your shareholders after taxes?

Mr. COLLADO. That is about right.

The CHAIRMAN. And for every dollar that you managed to pay from after tax profits to your shareholders, the Government is collecting about $14 in taxes, $5.6 billion in taxes you just said?

Mr. COLLADO. Some Government is; yes.

The CHAIRMAN. Some Government?

Mr. COLLADO. Some Government somewhere in the world, including state governments, foreign governments.

The CHAIRMAN. If they are getting $14 out of you for every dollar that you are managing to pay out in dividends, they are doing pretty well, aren't they?

Mr. COLLADO. Senator, sometimes I think we are one of the greatest tax collecting organizations in the world.

The CHAIRMAN. Thank you.

Senator CURTIS. Mr. Chairman.

I would like to ask the panel a question. I have a special responsibility toward the State of Nebraska. Prior to World War II, we did not have any oil. A little bit of oil was found in southeast Nebraska, but after 2 or 3 years no mention was made of it. In the Panhandle of Nebraska we have some activity going on now in two, three or four counties.

As I read the papers, I find once in a while the name of a large company that I recognize. Oftentimes the concerns drilling the wells are not nationally known concerns.

These producing wells are very hard to find. We have not found any yet of any rich deposit. We have not found any as yet that appeared to have a long sustaining production. As a matter of fact, even though it is a very infant industry in my State, most of it is over the peak.

On the other hand, it means a great deal to us. My question is this, If the House-passed bill is enacted into law, what will be the effect upon an oil industry in a State such as mine, the State of Nebraska?

Mr. DUNLOP. Senator, we were one of the companies that several years ago had a rather extensive activity in the State of Nebraska, with not too distinguished success. We drilled a number of these shallow wells, and developed a certain amount of reserve capacity and production.

We did it under the economic and tax climate that existed at that point in time, but because the results were generally uneconomic. Even under the existing situation, we have not felt that with the shortage of funds that are available, that we were justified in pursuing that line of exploratory effort any further.

Senator CURTIS. But some people are going on. I am not asking you why your company chose a particular course.

My question is if the House bill becomes law, what in your opinion is the prospect of this industry? Now I think we are producing more oil than we consume in the State of Nebraska. I know that it has added materially to the tax base in areas affected. What will be the effect of the House bill on oil production in any State similar to the one I describe in Nebraska?

Mr. DUNLOP. I was just trying to indicate, sir, that the results having been unsatisfactory under existing circumstances, I would seriously question that the industry as a whole would be disposed to mount a substantial exploratory effort in those areas where the promise of success was not substantial, and I suspect that under the present known geological information that is available in Nebraska, that unfortunately that would quite possibly be the circumstance.

Senator CURTIS. Do you have any idea what it costs to bring in a well there?

Mr. DUNLOP. Yes. In the shallow production in Nebraska we were drilling in the neighborhood of 3,000 to 4,000 feet, talking in the neighborhood of maybe $35,000 to $40,000, in that general area.

Senator CURTIS. Now, I would like to ask the panel another question. Is it true that the United States is on the verge of facing a shortage of natural gas? If so, was it caused in any considerable degree by any act taken by the U.S. Government? I do not care who answers.

Mr. DUNLOP. I had spoken to that point a few moments ago, and all I would reiterate is that last year, for example, our discoveries of gas were considerably less than the amount that was consumed by the American people, and it is our opinion that discovery was less than it otherwise might have been, had there been an adequate price incentive made available to the industry. You are familiar, Senator, that the wellhead price of gas is under the control of the Federal Power Commission, and those wellhead prices in our opinion, as determined by the

Commission, are woefully inadequate to stimulate the degree of exploration and development that should occur, if we are going to develop the necessary gas reserve position.

Senator CURTIS. Is it your honest opinion then that if the homes, businesses, and other places that are set up to burn gas for heat some day in the not too distant future find that there is not enough gas, that part of the responsibility goes back to an erroneous national decision made with respect to controlling the price of gas at the wellhead. Is that your opinion?

Mr. DUNLOP. That is correct. I would just like to indicate a little further data on that. If you go back 10 years, we had a reserve position in terms of years' supply of natural gas of somewhere around 20 years. Now that does not mean that gas could all be produced efficiently and economically within a 20-year period. But taking that as an index of available supply, as a result of the developments in the last few years we are now down to a 15-year reserve index of gas supply, and if the conditions continue as they were in 1968, that reserve index would suffer further decrease, Senator Curtis.

The CHAIRMAN. Thank you very much, gentlemen.

Senator MILLER. I have a question. On the basis of your interesting testimony regarding your own company's profit operations, am I correct in stating that there is no necessary relation between gross sales and net profit of a company, of a petroleum company?

In other words, for example, take company A that has $1 million in gross sales, company B has $2 million in gross sales. Is it not possible that the first company with only $1 million in gross sales may end up with more net profit than the second company with $2 million in gross sales?

Mr. COLLADO. That is of course correct, Senator. I think that you will find that the ranges around an average would not be perhaps as great as your example might suggest, but obviously a company that happens to have a very prolific source of oil will probably have a greater return on its investment, and a greater percentage of earnings to gross sales than a company that has relatively high cost oil reserves or may even have to buy from other producers a good deal of the oil that it refines and markets. These things happen in a big industry, and you will have a big range.

I think that we are interested in two things here. What is the range. Obviously each of us tries to have our company in terms of returns the most successful and the most profitable and we work very hard at it. I would like to think that we do better than other people.

Second, though it is a question of trends. What I was talking about in terms of the tax bill, and I am now talking about the worldwide tax bill, or the tax take of governments wherever they may be located, the trend for total taxes to increase has moved much more rapidly in the case of our company than have either gross sales or net earnings after taxes, and I think this has been the general experience of the oil industry.

Senator MILLER. For example, what I am getting at, let us take a company with $2 million in gross sales and it has a lot of intangible drilling and development costs because it does a lot of exploration and development. It may end up with very little net profit after taking off the intangible drilling and development costs. Another company with $1 million in gross sales may have no program for exploration and development and so it may end up with a higher net profit than the corporation with the larger gross sales, is that not so, Mr. Collado?

Mr. COLLADO. That is quite possible, Senator. The extreme case of course can be a company that has no producing at all. There are some such companies. They will probably have a pretty modest return in the United States, but they may have a net profit year after year on marketing and refining. Those who are more venturesome and go looking for oil over a period of years may have a considerable profit. They may not have a profit as recorded for tax calculations in those years when they are carrying on a particularly vigorous exploration effort.

You will notice if you read the history of companies over 10, 15, 20 years that these things for individual companies go in some cycles.

Senator MILLER. Now another question.

The CHAIRMAN. Gentlemen, if I may, Senator, I am going to ask that the panel of witnesses, which of course is presenting very important evidence, make themselves available in our conference room here. That is where our committee meets. Senator Miller, Senator Hansen, and others can ask questions there.

Senator MILLER. I only have one more question.

The CHAIRMAN. Senator Hansen wants to interrogate the witnesses too. I want to get on with other witnesses.

Senator MILLER. May I ask one more question, please, and then I am through. I do not have quite the same problem that Senator Curtis has because there is no producing oil to be found in the State of Iowa, but I think Senator Curtis and I as well as other Members of the Senate have a similar problem, especially out in our area we have a lot of farmers using tractor fuel, and of course all of us have a lot of consumers using automobile gas and oil.

I understand that the position of the panel is that if the 27½ percent depletion is cut to 20 percent, that this will result in additional costs to consumers. Is that the position of the panel?

Mr. MYERS. Senator Miller, it has to result in one of two things, either additional cost to consumers or a lower level of investment in the industry, and in all probability it will be some combination of those two things. But to answer your question directly, there is every reason to believe that if these incentives are taken away, the cost of motor fuel to the consumer will go up.

Senator MILLER. Thank you.

Senator HANSEN. Mr. Chairman, if I could—I have been restricting myself to one question per witness. May I be privileged to ask two. I would like to ask Mr. Collado how do you reconcile your views with those of Mr. Dunlop? Isn't your position in conflict with his?

As I understand his testimony, he wants to strengthen our domestic petroleum position. You want to strengthen our foreign position?

Mr. COLLADO. Senator, you have raised a very reasonable question. I do not believe there is any incompatibility at all. As you will recall from statements that he made as well as some of those I made in that impromptu initial comment on Alaska, we do not find that under the most favorable circumstances of tax policy, import policy, et cetera, that we envisage, that it would be possible to find and produce enough oil say in the year 1980 or 1985, which is what you have to look at when you are talking national security, to keep pace with the increase in demand. So under any projection that we have seen, that we have made ourselves or anyone else, we will be importing much more from Canada, from Venezuela, from overseas generally than we are today, and our own projections are that this mounts very rapidly.

Under those circumstances it is completely compatible simply because of U.S. consumption to seek a strong U.S. position abroad, so that those imports can be forthcoming, and a diversified position maintained abroad so we can have a variety of sources and not be completely dependent on certain countries that, as was mentioned earlier, might seek to put the squeeze on us, or might be prevented from serving us for one reason or other.

Beyond that, as Mr. Dunlop and I have quoted in our longer statements, the Department of Defense has pointed out the importance of our allies also receiving oil. The foreign oil situation is very important to our allies.

I do not think there is any incompatibility at all. I only would like to stress even more perhaps than Mr. Dunlop the importance of the domestic part of this thing.

Senator HANSEN. I do have one question if I may for Mr. Myers.

Earlier this week our distinguished colleague, Senator Proxmire, testified that the rationale for the depletion allowance "is supposedly rooted in national security. Without the depletion allowance" so the argument goes, and these are his words:

> We would not explore for the oil which we need in order to protect ourselves from possible interruptions in our oil supply.

Then he goes on to observe that:

> This myth was destroyed by the CONSAD report. CONSAD after a detailed study of the oil industry found that we would experience a mere 7 per cent decline in our discovery of oil reserves from a 12-year reserve to an 11-year reserve.

Now, as I recall your testimony, you say that there are many flaws in the Consad study. These are outlined in your so-called reference to attachment A. You continue:

> The principal error which makes the study irrelevant is that the economic model used in the study assumes that there is no relationship between the level of crude oil production and industry profitability.

Then you conclude:

> This of course is nonsense, and no credence can be given to the study.

My question is since depletion and a lot of other things are all interrelated insofar as the profitability of this industry is concerned, I would ask you what would be the effect upon the supply of oil we have if the depletion allowance were cut from its present 27½ percent to 20 percent?

Mr. MYERS. Senator Hansen, the best estimate that we are able to make, and this is on an arithmetic basis, is that the suggested reduction from 27½ percent to 20 percent would result in a decrease in exploration and development expenditures of at least one-fifth. I will not take up your time going through the arithmetic. The arithmetic is furnished in the detailed statement, but we feel that the estimate of a reduction by one-fifth is on the low side.

Senator HANSEN. Thank you, Mr. Myers.

Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, I think I ought to make it clear to our audience that we have a situation here that requires us to press ahead as fast as we can with this measure, because the Democratic Policy Committee voted some time ago that the revenue bill necessary to finance this Government should not be passed without a tax reform bill. And this Senator said that he would, if he could, try to prevail upon the committee to report this bill by the end of this month. Let me show you something.

Here is 2,000 pages of testimony that has been presented so far, and the policy committee should be aware of what has been said here. And here is about another thousand pages of questions and answers that we have had before this committee already, and we have about 2 more weeks. We have five more volumes to add on top of this that have not yet been edited, and we have about another ten days to go. So I hope you will understand why the chairman is pressing to try to make the testimony as brief as possible.

If the Senators want to ask this distinguished panel to make themselves available for further questions they will be invited to come back this afternoon if someone wishes to request that.

Senator FANNIN. Mr. Chairman, I have not asked my one question.

Mr. Myers, you and the panel thoroughly covered the depletion allowance rate reduction. Could you restate the basis for your objections to the inclusion of percentage depletion and intangible drilling costs in the category of limit on tax preference? I was out of the room. I know that this was in your testimony, but I wanted to be sure that I understood just exactly what you were referring to.

Mr. MYERS. We feel that the inclusion of those two items, percentage depletion and the intangible drilling costs, in the limited tax preference, particularly in the case of the independent operator, very much dilutes the incentives that are intended by the statutory depletion and by the option to expense intangibles. This really comes about in an indirect way. These are held out to the independent operator as an incentive, but through the method of limited tax preference, they are taken away from him somewhat indirectly.

It is our feeling that this will greatly reduce the incentive for the independent operator to continue his exploration for oil.

Senator FANNIN. My answer from a selfish standpoint would be my State of Arizona has not been as fortunate as the State of Nebraska. We have perhaps produced one-tenth of 1 percent of the product that is being used, so I am concerned.

One other item that you talked about and I would like to get closer to home when we talk about these foreign depletion allowances. I wonder with the elimination of foreign depletion would it have any substantially adverse impact on the competitive position of Canadian oil in the northern United States market that we are all concerned about?

Do you feel it would have any great effect?

Mr. COLLADO. The Canadian law provides a depletion allowance in a somewhat different form from ours; it is a third of net income. If we were to eliminate the depletion allowance in the United States, the U.S. companies with branch operations up there would find that they would be paying on a U.S. tax basis a higher tax rate than they would now be paying in Canada. As a result they would be subject to further U.S. tax in all probability. It would depend a bit on the circumstances of each company.

Beyond that, if we gave up the depletion allowance here, there might be pressures in Canada that would suggest reducing it up there. Well, the total Canadian tax before the depletion allowance runs up very close to 60 percent from both income and withholding taxes. Thus elimination of U.S. depletion allowance would make operations in Canada considerably less profitable, and this will have impacts up there, as well as on our balance of payments. We take in quite a lot of balance-of-payments income from the return on our investments in Canada. I believe that I have answered your question correctly.

Senator FANNIN. I think that you have. In other words, the impact would be considerable then, and that it would have a detrimental effect as far as the costs of fuel in the northern part of the United States?

Mr. COLLADO. We think so.

Senator MILLER. Under the provisions of section 431 of the bill, which requires that certain tax benefits be recouped, is there any limit on the time between which the tax benefit is received and the required recoupment?

Mr. COLLADO. In section 431 of the House bill, there is no limit as to the time which can elapse between the deduction of losses and the operation of the recapture provision. As I pointed out in my written statement submitted to the committee (p. 19 of my written statement, p. 25 of the committee print), this means that even unrelated projects undertaken many years after the losses occurred in a foreign country could be burdened with the additional taxes imposed by this provision. However, the Treasury indicated in its detailed statement submitted yesterday that it would submit recommendations for technical changes which would limit the number of years to which the taxpayer could be affected by the recapture provision. The Treasury did not indicate the number of years of limitation it would recommend. However, at the same time, Treasury has recommend eliminating the annual 50 percent limitation on recapture as is provided in the House bill. This change recommended by the Treasury could result in the taxpayer paying 100 percent or more of his income in a foreign country in taxes for the years required to effect the recapture.

Senator MILLER. Is the subsequent activity resulting in recoupment required to be related in some way to the activities resulting in the prior loss producing the tax benefit?

Mr. COLLADO. No; any subsequent activity resulting in a profit in the country in which the losses occurred could be burdened with the recapture provision, and I refer again to my written statement, page 19 (p. 25 of the committee print).

Senator MILLER. If the project is abandoned, or if it is successful but is nationalized and confiscated, is the prior tax benefit then not required to be recouped?

Mr. COLLADO. Under section 431 of the House bill, recapture or recoupment is require in cases in which the property which gave rise to the loss is subsequently abandoned or expropriated without compensation. The requirement is that in either of these circumstances gross income for tax purposes must be increased by the amount of the prior losses. I have noted the peculiar inequities in this provision in my written statement submitted to this committee (pp. 19–20 of my written statement, or pp. 25–26 of the committee print). However in its technical statement submitted yesterday, the Treasury has recommended that in cases of disposition of property before recapture of prior losses has been achieved, that the amount of recapture be limited to the amount of gain on such disposition. Thus, the Treasury's recommendations would not require recapture in cases of abandonment of the properties or of expropriation without adequate compensation.

Senator MILLER. Thank you.

Senator FANNIN. Mr. Collado, I understand the theory underlying the separate foreign tax credit limitation for mineral income in section 432 is that some part of foreign taxes on mineral income are necessarily disguised royalties.

Do you know whether the Treasury has taken the position that if royalties are paid to the foreign government which at least equal those paid in the United States, it would not consider the foreign tax a disguised royalty?

Mr. COLLADO. As Assistant Secretary of the Treasury Cohen stated when he appeared before this committee, section 432 presumes that any foreign tax on mineral income in excess of the effective U.S. tax on such income is a disguised royalty. As I noted in my written statement (pp. 22–23 of the statement; pp. 28–29 of the committee print), on further examination of the hidden royalty question the Treasury has concluded that the presumption underlying section 432 is improper, and has, therefore, recommended in lieu of section 432 that excess credits for foreign taxes on foreign mineral income resulting from the allowance of U.S. percentage depletion (which the Treasury has recommended be reinstated on foreign production) not be available to be applied against other income. As I stated in my testimony, we believe this proposal should be studied further.

Senator FANNIN. Is it true that royalties at least equal to those paid in the United States are paid to countries like the United Kingdom, Canada, and Venezuela?

Mr. COLLADO. As I indicated in my written statement (p. 22 of the statement and p. 28 of the committee print), royalty payments to governments in foreign producing countries are generally as high as, and in some cases considerably higher than, royalties paid on production in the United States. In the countries you have mentioned specifically, the effective rates of royalty are at least as high, or higher than the effective rates of royalty of from 12½ to 16⅔ percent paid on production in the United States. In the case of Venezuela, the effective rate of royalty is considerably higher than in the United States, and exceeds 25 percent.

Senator FANNIN. Yet I take it section 432 would apply to mineral operations in all foreign countries?

Mr. COLLADO. It would apply in all foreign countries.

Senator FANNIN. Thank you.

Senator WILLIAMS. Mr. Chairman, I do not have any questions but I want to state to the panel that while there may be a slight disagreement among us as to the provisions of the bill, you have made an excellent presentation this morning. Thank you.

The CHAIRMAN. Thank you very much, gentlemen.

(Material referred to previously and the prepared statements of the panel follow. Oral testimony of the next witness commences at page 4483.)

STANDARD OIL CO.,
INCORPORATED IN NEW JERSEY,
New York, N.Y., September 29, 1969.

PHILLIP AREEDA,
Executive Director, Cabinet Task Force on Oil Import Control,
Washington, D.C.

DEAR MR. AREEDA: In response to your request, I attach a memorandum estimating the impact on U.S. oil production of a reduction in the oil depletion rate from the present 27½% to 20%.

While the estimates for each of the years through 1985 have been derived from our models and expressed in precise terms, I am sure you recognize that we did not intend to imply that such a degree of precision is possible in making the estimates for each of the specific years. We have much greater confidence, of course, in our projection of the *ultimate* impact over a long period of time of a 20% depletion rate than we can have about the impact in any one year, or over a relatively short period of time. We are, of course, prepared to discuss our estimates with you or to provide any additional information which you may find helpful.

I assume that you will want to insert the attached material into the public record, and I have no objection to your doing so.

With best regards.

Sincerely yours,

EMILIO G. COLLADO.

Attachments.

EFFECT OF REDUCING STATUTORY DEPLETION RATE TO 20 PERCENT ON U.S. OIL PRODUCTION

The attached table and chart show the effect on domestic crude oil production of reducing the statutory depletion rate from 27.5 percent to 20 percent. As indicated, the reduced economic base for new exporation would ultimately cause a reduction in production of 600,000 barrels per day in 1980 and 1,400,000 barrels per day in 1985.

Recent detailed analyses of the sensitivity of oil exploration and development to changes in producing economics were the basis of this assessment. It should be recognized that only the effects of changes in producing economics were considered in this evaluation. That is, it does not include any effect due to a shortage of capital, either resulting from reduced industry cash flow or reduced investor interest. Lease bonuses would be reduced by about $65 million per year or about 10 percent. The fact that lower lease bonuses would tend to offset the change in tax treatment was fully considered in assessing the producing economies.

It was assumed that initially only the production from future reserves would be affected. A reduction in exploratory oil wells drilled of about 1,000 wells per year and a reduction in development oil wells drilled of slightly less than 2,000 wells per year would result.

The assumption that production from currently proved reserves (reserves currently booked by the American Petroleum Institute) would be relatively unaffected is probably conservative. The reduced industry cash flow would result in some expenditures being omitted that are required to produce these reserves.

The effect on the production rate of such a change in producing economics is delayed for several years primarily due to two factors. 1) As long as excess producing capacity exists a decline in reserves and producing capability is not reflected in the production rate. 2) There is often a sizable delay between the decision which commits an operator to drill and significant production from the prospect. However, as can be seen on the attachments, the effect increases rapidly have been influenced by the reduced producing economics.

Thought it is reasonable to assume that the magnitude of the effect on exploration for gas would be similar, the effect on condensate and gas plant liquids production was not quantified. Also, it was assumed that synthetic crude production (1.0 million barrels per day in 1985) would be unaffected.

EFFECT OF REDUCING THE STATUTORY DEPLETION RATE FROM 27.5 TO 20 PERCENT ON U.S. CRUDE OIL PRODUCTION

Year	U.S. crude oil production—MMBPD: Standard Oil (New Jersey),[1] base case	U.S. crude oil production—MMBPD: Statutory depletion rate 20 percent, Jan. 1, 1970	Year	U.S. crude oil production—MMBPD: Standard Oil (New Jersey),[1] base case	U.S. crude oil production—MMBPD: Statutory depletion rate 20 percent Jan. 1 1970
1969	8.8	8.8	1978	10.8	10.4
1970	8.9	8.9	1979	11.1	10.6
1971	9.0	9.0	1980	11 4	10.8
1972	9.2	9.2	1981	11.7	10.9
1973	9.4	9.4	1982	12.0	11.1
1974	9.6	9.5	1983	12.4	11.3
1975	9.8	9.7	1984	12.9	11.6
1976	10.1	9.9	1985	13.3	11.9
1977	10.5	10.2			

[1] Assumes no change in oil taxation.

PRESENTATION ON PETROLEUM INDUSTRY EXPLORATION AND PRODUCTION COSTS AND VOLUMES FOR THE CABINET TASK FORCE ON OIL IMPORT CONTROLS, SEPTEMBER 16, 1969

(Mr. M. A. Wright, Humble Oil & Refinery Co.)

FUTURE SUPPLY FORECAST

1. This picture of long-range outlook was presented in the original submission. It illustrates that with current incentives, sufficient reserves could be found to satisfy demand through 1985.
2. The importance of future reserves is clearly shown on this chart. Existing reserves down to 1.7 MME/D in 1985. Assumes 72 billion barrels of crude reserves added.
3. The following presentation explains basis for this forecast.

U.S. INDUSTRY CRUDE OIL

Area	Cumulative production MMB	Remaining booked reserves MMB	Forecast reserve additions, MMB/year									
			1969	1970	1971	1972	1973	1974	1975	Average year 1976–80	Average year 1981–85	Total, 1969–85
Inland (ex-Alaska)	84,328	26,451	1,790	1,724	1,640	1,572	1,523	1,433	1,362	1,132	854	20,974
Offshore (out to 2,000 ft. water depth)	2,379	4,169	865	784	763	758	796	830	880	1,062	1,712	19,546
Alaska (inland)	89	87	3,500	1,500	1,400	1,200	800	606	500	1,590	2,810	31,506
Total, United States	86,796	30,707	6,155	4,008	3,803	3,530	3,119	2,869	2,742	3,784	5,376	72,026

Note: 1969–75 average year, 3,750; 1976–80 average year, 3,780.

AREA BREAKDOWN OF RESERVE ADDITIONS

1. This chart shows an area breakdown of the future reserve add estimates. The methods used to make this estimate are attached in a letter from Mr. M. A. Wright to Senator Philip Hart.

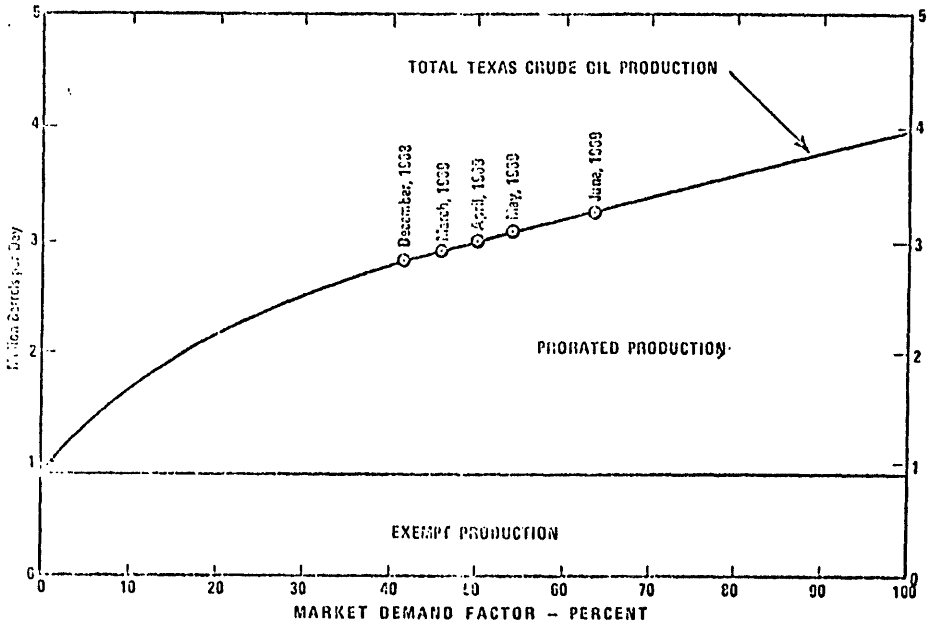
2. It is anticipated that inshore (ex Alaska) reserve additions will total 21.0 billion barrels by 1985. This is a relatively mature exploration area.

3. Offshore areas include the Gulf of Mexico, Atlantic and Pacific, and offshore Alaska. No reliable estimate for a specific area could be made, but the estimate for the total area should be more accurate.

4. The current estimate for Alaska (inland) reserves is 31.5 billion barrels. This assumes additional acreage in NPR-4 and the wildlife refuge are opened for exploration.

5. The importance of acreage becoming available from lease sales is clearly evident since there is shown to be potential for finding more reserves in the latter period.

TEXAS INDUSTRY CRUDE OIL PRODUCTION
RESPONSE TO MARKET DEMAND FACTOR

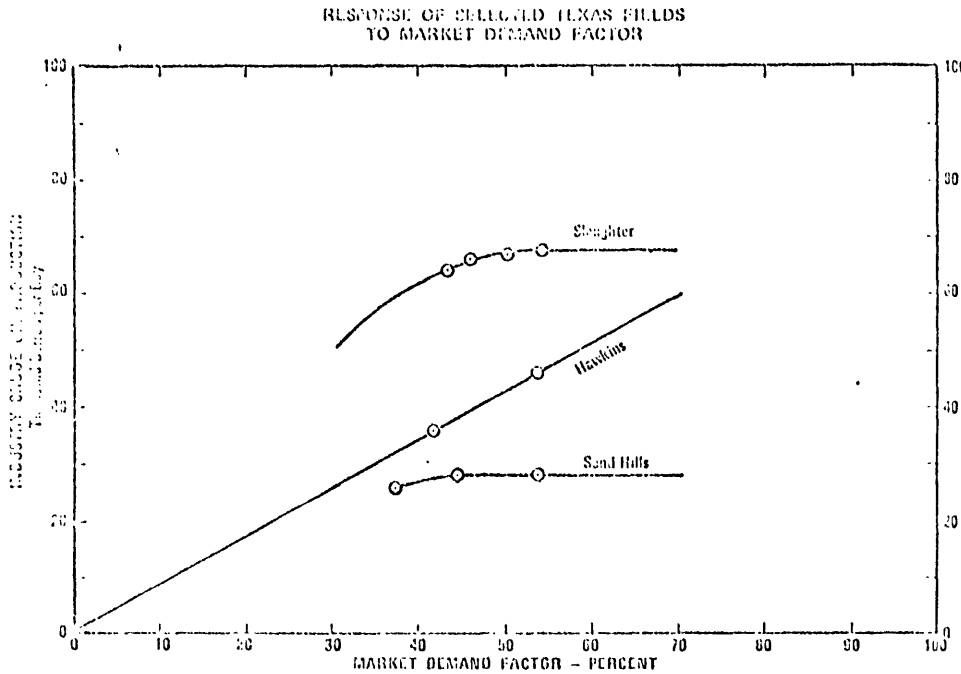


TEXAS RESPONSE TO PRORATION FACTOR

1. The next chart illustrates the effect that proration has on production from existing reserves in Texas.

2. In Texas, production at a 50 percent proration factor is approximately 3 MM BPD. If the proration factor were raised to 100 percent, production would grow to almost 4 MM BPD. The fact that production response is not proportionate to the increase in proration factor is due to the almost 1 MM BPD of exempt production and the large number of fields that have limited capacity.

3. This curve represents a specific point in time. Similar but lower curves would apply in future years.

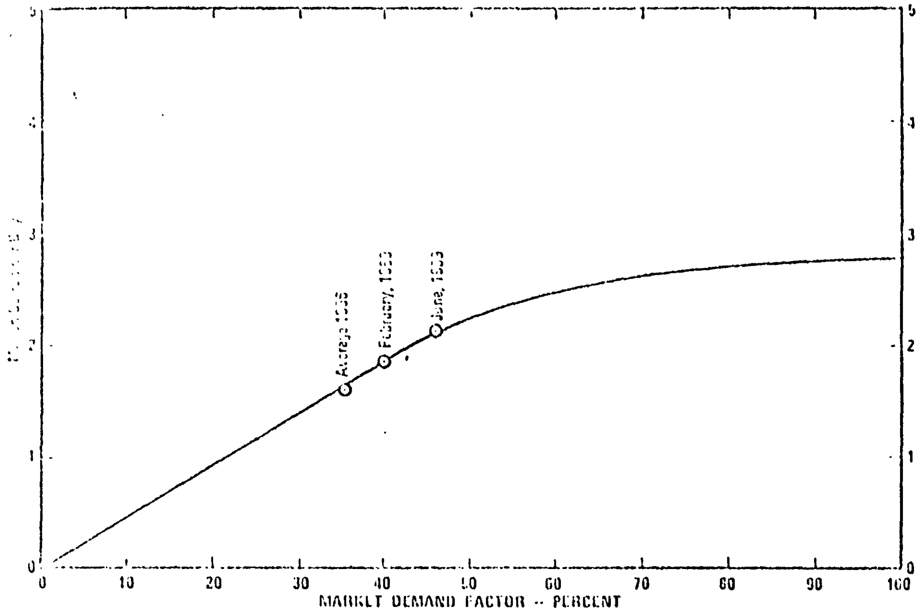


RESPONSE OF SELECTED TEXAS FIELDS TO MARKET DEMAND FACTORS

1. An example of the varying field response in Texas is shown. The Hawkins field has good response to increased market demand factors.

2. The Slaughter and Sand Hills fields are both under waterflood and show very little response.

LOUISIANA INDUSTRY CRUDE OIL PRODUCTION
RESPONSE TO MARKET DEMAND FACTOR



LOUISIANA RESPONSE TO PRORATION FACTOR

1. This chart shows the estimated response of Louisiana crude oil production to proration factor.
2. Poorer response is projected at the higher proration factors.
3. All industry estimates of producing capacity in Louisiana (IPAA, API) are in substantial agreement.

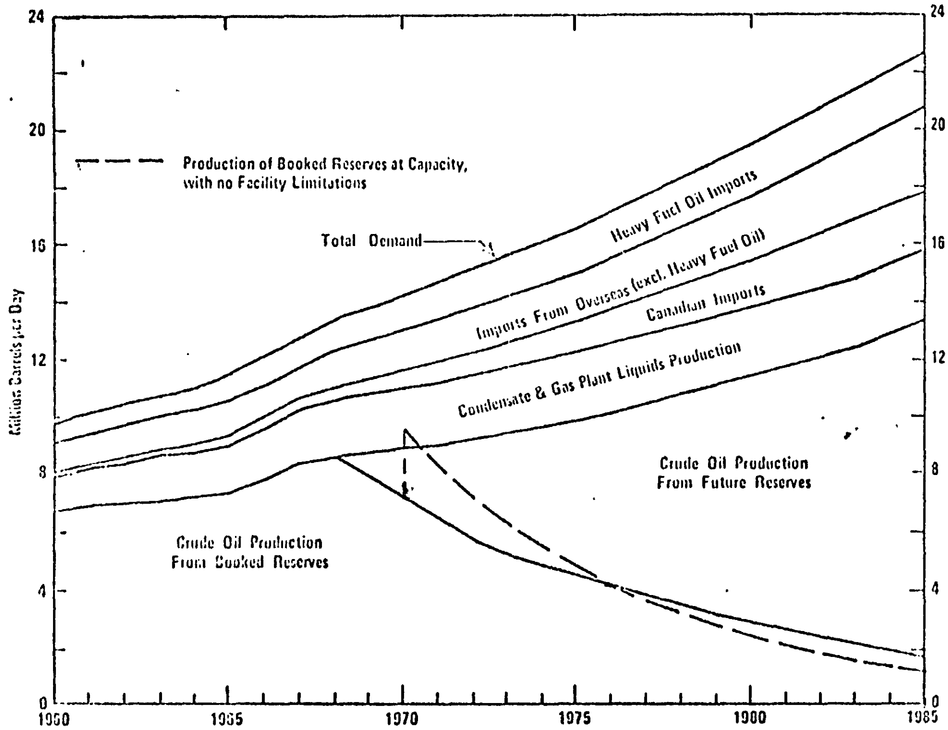
WELLHEAD CAPACITY OF MAJOR TEXAS FIELDS

Field	Production rate at 100 percent MDF MB/D	Wellhead capacity MB/D	Wellhead capacity above 100 percent MDF MB/D
East Texas	275	500	225
Kelly Snyder	180	250	70
Yates	50	100	50
Tom O'Connor	75	100	25
Anahuac	35	100	65
Hastings	75	160	85
Van	50	80	30
Hawkins	87	140	53
Conroe	50	120	70
Total, major fields	877	1,500	673

MAJOR FIELD CAPACITY

1. There is additional capacity in selected fields in Texas above the 100 percent market demand factor. It is primarily located in the nine major fields shown.
2. The total capacity above the 100 percent proration factor is approximately 800 m BPD.
3. While this capacity is available, it would require significant expenditures in production, pipeline, and storage facilities and in many cases this would not be economic due to the rapid fall off of capacity once the fields were produced at high rates.

U.S. LIQUID PETROLEUM SUPPLY AND DEMAND
WITH CONTINUED IMPORT CONTROLS



EFFECT OF MARKET DEMAND PRORATION ON LONG RANGE SUPPLY

1. While there is additional capacity available in Texas and Louisiana, it would only have a short range effect if fully utilized. The chart illustrates the potential to raise production in the U.S. using the spare capacity previously mentioned and shows that after 1976 production from existing reserves would be less than had proration continued.

2. Facility and pipeline limitations would preclude the full utilization of this capacity. The effective spare capacity in 1970 would be only about 1.8 MM BPD, as shown in exhibit D of our original submission to the task force.

3. Although facility and pipeline bottlenecks could be removed, the large expenditures required would be uneconomic because of the short-term nature of this capacity.

U.S. oil industry—exploration-production function cost 1962–66 period

1962 to 1966 exploration costs, $MM	11,604
1962 to 1966 drilling and equipment costs, $MM	12,301
1962 to 1966 production costs, $MM:	
Operating	9,259
Production and ad valorem taxes	2,978
Royalty	9,023
Total	21,260
December 31, 1968 booked reserves credited to 1962–66 new field discoveries, MM gross equivalent barrels	5,860
Estimated ultimate hydrocarbon production from 1962–66 new field discoveries, MM gross equivalent barrels	10,370
1962 to 1966 hydrocarbon reserve additions from extensions and revisions plus new field discoveries, MM gross equivalent barrels	20,554
1962 to 1966 hydrocarbon production, MM gross equivalent barrels	18,786
Exploration costs, dollar/gross equivalent barrel	1.11
Drilling and equipment costs, dollar/gross equivalent barrel	0.60
Production costs, dollar/gross equivalent barrel	1.13
Total costs, dollar/gross equivalent barrel	2.84

U.S. INDUSTRY COSTS

1. An analysis of overall industry costs can be made from data published by the joint association survey. The costs are broken into exploration, drilling and equipping, and production costs. From 1962–1966 the industry spent a total of $45.2 billion dollars in these categories.

2. By using statistical extrapolations of the new reserves discovered during that period to determine their ultimate size, the finding cost for new reserves was $1.11 per equivalent barrel.

3. By using the reserve additions from extensions and revisions and discoveries, the drilling and equipment cost was $.60 per barrel.

4. The production costs including royalty amounted to another $1.13 per barrel. The overall cost was $2.84 which compares with the average crude price of $2.88 per barrel at that time.

5. These are not the only costs to an operator. At current interest rates the normal 3-year delay from lease purchase to production may add an additional cost of $0.20 per barrel to the $1.11 per barrel finding cost. Other costs include federal and state income taxes. The return on investment anticipated by the operator must also come out of this difference.

EXPLORATION-PRODUCTION FUNCTION COST DATA FROM VARIOUS SOURCES

	From JAS data 1962–66	From H. J. Struth data 1962–66[1]	Foster & Associates 1962–66[2]: Gulf of Mexico	Foster & Associates 1962–66[2]: Inshore southern Louisiana	Foster & Associates 1962–66[2]: Other continental United States
Exploration cost: cost/gross equivalent barrel	1.11	0.72	1.19	1.17	1.07
Development cost: cost/gross equivalent barrel	.60	.74	(3)	(3)	(3)
Producing cost:					
Cost/gross equivalent barrel	.65	.74	.59	.84	.77
Royalty adjustment[4]	.48	.48	.48	.48	.48
Adjusted cost/gross equivalent barrel	1.13	1.22	1.07	1.32	1.25
Total exploration-production function cost	2.84	2.68	2.26	2.49	2.32
Adjusted total exploration-production function cost[5]	2.84	2.68	2.85	3.06	2.79

[1] Reported in May 1967 World Oil; crude oil only; gross barrel basis instead of net as reported in World Oil.
[2] As prepared for the Department of the Interior, Bureau of Land Management, December 1968.
[3] Exploration and development costs included under exploration costs.
[4] Royalty assumed to be 16.67 percent (1/6) 1962–66 average crude oil price $2.88 per barrel.
[5] Foster & Associates exploration-development costs were adjusted for the current estimate of ultimate reserves found by new discoveries in the period 1962–66.

COMPARISON OF INDUSTRY COST ESTIMATES

1. Other studies of finding, developing, and producing costs have been published and the results are tabulated. All of the studies show essentially the same result.

2. While the entire industry is not at a high profit level, the point driving most operators on is the potential to make higher returns. The wide variation of bids in recent lease sales indicates the wide assessment of risks and profit potentials placed on prospects by various companies. Some examples of the returns on several sales will be shown along with some individual company variations.

ECONOMIC RETURN FOR INLAND U.S. EXPLORATION (EXCLUDING ALASKA)[1]—7 MAJOR COMPANIES, 1963-67

Company	Exploration expenditure	Reserves discovered (barrels)[1]	Finding cost (dollars per barrel)	DCF return (percent)
A			0.61	9-12
B			.85	6- 9
C			1.03	5- 8
D			1.09	5- 7
E			1.13	5- 7
F			1.44	3- 5
G			3.93	(3)
Total	$1,668,000,000	1,399,000,000	1.19	4- 6

[1] Estimated by Humble from public data.
[2] Oil equivalent barrels.
[3] Negative.

ECONOMIC RETURN FOR INLAND U.S EXPLORATION (EX ALASKA)

1. This chart illustrates the economic results on exploration in inland U.S.A. (excluding Alaska) from 1963–1967. The industry spent $1.7 billion and discovered 1.4 billion barrels for a finding cost of $1.19 per barrel. The average industry return was 4 to 6 percent.

2. Individual companies finding costs ranged from $.61 per barrel to $3.93 per barrel, and the returns ranged from negative to 12 percent.

3. The first chart showed that 21.0 billion barrels could still be found in this area, but it is obvious that the economic environment must remain stable to do this.

ECONOMIC RETURN FROM COOK INLET EXPLORATION[1]

TOTAL INDUSTRY

	Exploration expense (in millions)	Production investment (in millions)	Net oil production (million barrels)	Finding cost (per barrel)	DCF return (percent)
1966 STUDY RESULTS (BASED ON PRELIMINARY COST AND RESERVOIR INFORMATION)					
1951-65	$213	$349	919	$0.23	20.0
1969 STUDY RESULTS (BASED ON LATEST COST AND RESERVOIR INFORMATION)					
1951-68	520	870	627	.71	3.5

INDIVIDUAL COMPANY RESULTS

Company	Finding cost (per barrel)	DCF return (percent)
A	$0.41	17
B	.58	16
C	1.90	(2)
D	1.29	(2)
E	1.40	(2)
F	1.74	(2)

[1] Estimated by Humble from public data.
[2] Negligible.

ECONOMIC RETURN ON COOK INLET EXPLORATION

1. The difficulty in exploring for oil is shown by economics on Cook Inlet. An early study showed that industry should expect a 20 percent rate of return on fields discovered between 1951 and 1965. It was estimated that almost a billion barrels would ultimately be in these fields and total exploration costs would be $213 MM.

2. A 1969 study of the same area showed that exploration from 1951 through 1968 would result in only a 3.5 percent return. Several things happened since the 1965 study that changed the results. First of all the fields did not respond as well as anticipated and reserve estimates had to be lowered. Also the production costs were increased significantly with the need to inject water in the reservoirs. The last point is that no significant fields were found from 1965 to 1968 but substantial exploration expenditures were made.

3. Again some companies fared better than others with returns ranging from 17 percent to negative. Two-thirds of the companies will lose money over that period.

INDUSTRY OFFSHORE ECONOMICS [1]

[Dollar amounts in millions]

Year	State	Bonus	Est, rec. MMO. E. B.	Payout, years	Profit	D.C.F. (percent)
1954	Louisiana	$116	670	18	$593	7
1962	do	445	2,300	13	2,177	9
1967	do	510	1,270	12	820	7
1968	California	603	930	11	785	7
1968	Texas	594	240	None	−179	(2)
Total for 21 sales		3,360	7,150	13	5,090	6

[1] Estimated by Humble from public data.
[2] Negligible.

INDUSTRY OFFSHORE ECONOMICS

1. When leases are bid, the fierce competition generally keeps overall returns low. The industry results from 5 major sales are shown along with the overall industry results on 21 lease sales.

2. In general, most operators try for a reasonable return in the range of 10 to 15 percent. However the companies view the prospects differently and the most optimistic bidder gets the lease every time. This drives the average returns down below 10 percent as shown.

3. The risk is also shown in the Texas offshore sale which has been very disappointing and will show a loss for industry.

4. It can be seen from the results of the sales that a company will profit in some and lose in others, and the exploration program must be viewed in an overall sense to determining how effective it is. This is also why it is necessary to look at the overall costs of the industry rather than any particular field or basin.

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ESTIMATED ECONOMICS OF DEEPWATER DISCOVERY, OFFSHORE CALIFORNIA

Recoverable reserves (millions of barrels)	50	200
Number of producing wells	60	230
Peak production rate (barrels per day)	25,000	60,000
Water depth (feet)	1,000	800–1,400
Oil prices (per barrel)	$2.65	$2.65
Gas price (thousand cubic feet)	$0.25	$0.25
Economics (price per barrel):		
Exploration costs:		
Bonus	$0.800	$0.200
Other	.220	.055
Total	1.020	.255
Development costs:		
Production	.896	.800
Pipeline	.044	.075
Total	.940	.875
Operating costs:		
Other	.480	.550
Royalty	.460	.460
Total	.940	1.010
Grand total	2.900	2.140
Rate of return (percent)	(1)	8

[1] Negative.

SANTA BARBARA CHANNEL

1. With the current economic environment, the industry has looked for new reserves to the very limit of technology. An excellent example is the Santa Barbara Channel where leases were purchased in 1,800 feet of water. Prior to this the water depth record for exploratory drilling was 632 feet. Industry spent $603 MM for leases on 350,000 acres in the sale.

2. Humble spent $218 M for 154,000 acres in the sale. Since that time, an additional $11 MM has been spent to develop technology to operate in deep water. The costs will be extremely high in deep water. For example, Humble's deepest water platform is now in 170 feet of water and cost $2.5 MM. A platform in 1,000 feet of water in Santa Barbara will cost $25 MM.

3. To illustrate how much oil must be found to make a sale of this type profitable, two cases are shown. This assumes a prospect covering several leases with a total lease bonus of $40 MM. If a 50 MM barrel field is found, the exploration costs would total $1.02 per barrel and the prospect would be an economic loss. A field of this size might be developed however, so the operator could get part of his lease money back. If a major 200 MM barrel field were found, the return would be 8 percent. Of course, if that was the only field found for a company like Humble, the overall sale would still be an economic loss.

COMPARISON OF BIDS ON SELECTED TRACTS 1969 NORTH SLOPE OF ALASKA LEASE SALE

[Dollars in thousands]

Tract	High bidder	High bid	HO&R bid	ARCO bid	BP bid
57	Amerada-Hess, Getty	$72,277	$26,099	$26,087	$47,150
56	Amerada-Getty, LL&E, Placid; Hunt Int	43,555	8,499		14,156
36	Phillips, Mobil, SoCal	18,130	9,899		
33	Phillips, Mobil	12,100	6,400	1,043	
60	Amerada, Marathon, Getty, Placid, Hunt	53,031	2,301		
54	Mobil, Phillips	4,060	1,400	261	
67	Amerada, Hess, LL&E, Getty, Marathon	31,122	399		
61	Amerada, Marathon, La Land, Getty, Placid, Hunt	43,555			

PRUDHOE BAY

1. Another example of the varying costs and returns is the recent lease sale on the north slope of Alaska. The industry spent over $900 MM on leases in that sale.
2. The table shows that the companies who already have a lease position in that area did not bid in the same range as newcomers.

EXPLORATION ECONOMICS

[Dollar amounts in millions]

	Current tax rules	20-percen depletion allowance, capitalized intangibles
Bonus	$20	$20
Provit AFIT	$52	$48
Rate of return (percent)	13	11.5
Bonus reduction to gain equivalent rate of return		$3.2

EFFECT OF TAX CHANGES

1. Relatively low overall returns have been indicated for several competitive sales and in mature exploration areas. The bids were made on the basis of existing tax laws and any change in these laws will lower returns even more.
2. As an example, a typical bid for an operator is shown. For a bid of $20 MM the operator could expect a profit of $52 MM and a rate of return of 13%. However, if the depletion allowance was cut to 20% and it was required that successful intangible drilling costs be capitalized, the profit would drop to $48 MM and the return to 11.5%.
3. On future bids, under these changes, the operator would still try for the same return on his capital, and his bid would have to be lowered by 3.2 MM.

STATEMENT OF EMILIO G. COLLADO, EXECUTIVE VICE PRESIDENT, STANDARD OIL CO. (NEW JERSEY), NEW YORK, N.Y., IN BEHALF OF AMERICAN PETROLEUM INSTITUTE; MID-CONTINENT OIL & GAS ASSOCIATION; ROCKY MOUNTAIN OIL AND GAS ASSOCIATION; AND WESTERN OIL AND GAS ASSOCIATION

SUMMARY

We strongly urge that Sections 431 and 432, and Section 501(a) of H.R. 13270, applying to the foreign activities of U.S. petroleum companies, be rejected. By increasing the tax burden on U.S. petroleum companies' operations abroad, these provisions would seriously weaken the ability of U.S. companies to compete effectively with foreign oil companies, many of which receive substantial tax benefits and, in some cases, cash subsidies from their home governments. This adverse impact is likely to be felt particularly on the ability of U.S. petroleum companies to obtain concession rights in new producing areas, and thus the provisions would place important obstacles in the way of U.S. companies' participation in the future growth of the international oil industry. These measures must be assessed in the light of the contribution which U.S. petroleum investments abroad make to important U.S. national objectives.

Our national security requires that we maintain adequate and assured sources of oil to meet our growing economic and military needs for energy. Despite the high rate of growth expected in our domestic oil producing capacity in the future, the United States will have to rely increasingly on foreign-source oil to meet our growing requirements. The best way to provide that our country will have access to sufficient foreign-source petroleum is to encourage U.S. companies to continue to search for and develop these resources in diverse foreign areas.

The foreign oil investments of U.S. companies also make a substantial positive contribution each year to our balance of payments, and last year contributed about $2.5 billion to U.S. receipts of income and royalties and fees from abroad. Moreover, these investments have enhanced our economic welfare and have promoted economic progress in the developing countries.

Sections 431, 432, and 501(a) would also seriously undermine valid and long-standing principles of tax equity and of preventing international double taxation, which United States tax laws have traditionally sought to achieve. Section 501(a) would discriminate against the foreign activities of U.S. petroleum companies by denying them tax treatment comparable to petroleum operations conducted in the United States. Section 431 would double-tax individual parts of a taxpayer's income, while Section 432 would introduce international double taxation on the integrated petroleum industry operations abroad by denying to the mineral industry alone the effective use of the overall basis for applying the foreign tax credit. Such discrimination against foreign-source income, and against the mineral industry in particular, seems unjust and unwarranted. Moreover, enactment of these provisions seems unlikely to produce a significant amount of revenue for the United States. The Treasury has offered recommendations which would alleviate some of these problems.

STATEMENT

My name is Emilio G. Collado. I am a Director and Executive Vice President of the Standard Oil Company (N.J.), and my statement is submitted on behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association. My statement concerns the major provisions of H.R. 13270 relating to U.S. taxation of the petroleum industry's operations abroad. I fully concur with the views expressed in the statements submitted by Messrs. Dunlop, Spencer and Myers.

In our opinion, the changes in U.S. tax laws contained in H.R. 13270 applying to the foreign activities of U.S. petroleum companies ought to be rejected. The specific provisions that we urge be rejected are: Sections 431 and 432, which 501(a) which, in addition to reducing percentage depletion on domestic production, would eliminate percentage depletion entirely for foreign oil and gas production.

We have three principal reasons why we believe these provisions should be rejected. First, after careful analysis we have concluded that the provisions would be harmful to the national security interest of the United States and our foreign allies in maintaining adequate and growing foreign sources of oil. Second, we believe the provisions would be detrimental to the U.S. balance of international payments and general economic welfare. Finally, there enactment would seriously undermine long-established and accepted principles of tax equity and of preventing international double taxation.

National security of the United States and the free world

U.S. tax policy pertaining to the foreign activities of U.S. petroleum companies must, above all, be assessed in the light of the importance of these activities to the national interest of the United States in maintaining adequate and secure sources of oil to meet our growing economic and military needs for energy.

Today the United States consumes nearly 40 per cent of the oil consumed in the entire Free World, yet less than 10 per cent of the Free World's petroleum reserves are in this country. In the future we will have to rely increasingly on foreign-source oil to meet our growing requirements. The estimates vary, but considering currently known reserves and with reasonable assumptions about the future with respect to new discoveries and the development of synthetics, and assuming continuation of existing domestic tax incentives and import policy, the coverage of domestic demand for petroleum (including residual fuel oil) by domestic producing capacity is expected to decline from 93 per cent currently, to 83 per cent in 1975 and 76 per cent in 1[illegible]. These expectations do not rely on pessimistic assumptions of a lower rate of discovery of petroleum resources in the United States in the future than in the past, nor even on a simple projection of past trends. On the contrary, average annual discoveries in the United States, including Alaska and offshore, are expected to be considerably greater in the future than the recent past, provided that existing domestic tax incentives and import policy are continued.

Foreign-source oil is also of substantial strategic importance to our country. As the U.S. Department of Defense stated in its submission to the Task Force on Oil Import Control:

"In carrying out our treaty commitments, we, as a nation, face a variety of threats on many fronts. Despite the enormous and costly effort of our nation's intelligence organizations and resources, it is impossible to predict the place, time, scope, and contestants in any future emergency; hence, our logistics planners face a continuing challenge. It, therefore, follows that our national security extends far beyond the shores of the United States. *The Department of Defense reaffirms that it is in the best interests of the United States and, in fact, our national security dictates that we have in existence dependable, capable, and willing overseas sources to satisfy our petroleum needs on a global basis.*

"In summary, the DoD is primarily concerned with an assured adequate source of supply in close proximity to the area of need and at the lowest possible cost to the taxpayer. One fact is clear and that is the U.S. alone cannot realistically plan to fuel any Free World type of an emergency, therefore, we believe that no drastic action should be taken which would jeopardize our other Free World sources of supply. The interest of the DoD in expanding oil development by areas in order of priority is first the Continental U.S., secondly the Western Hemisphere and, thirdly other Free World areas. This order of priority includes, but is not limited to, the maintenance of a domestic production and refining capability to meet military and essential civilian requirements." (Emphasis added.)

Thus, the future availability of growing quantities of foreign oil is of great economic and strategic importance to the United States to meet our growing needs, both in the United States and for use in our military installations abroad. In the future, we will have to rely increasingly on sources elsewhere in the world—both our traditional sources of supply and new producing areas of the future.

Our allies, with more limited potential for developing domestic producing capacity, must rely to a much greater degree on foreign oil to meet their needs. For example, Western Europe currently imports 96 percent of its petroleum requirements. Moreover, energy consumption abroad is growing much faster than in the United States, and petroleum is supplying an increasing share. In the future, the United States will not be in a position to meet Europe's needs in the event of an interruption of supplies from the Middle East without impinging on U.S. consumption, as we were able to do during the last two Suez crises.

It seems clear that the future security of the United States and the Free World will depend on ready access to diverse and growing foreign sources of oil. In the case of the United States, the best way to provide future access to sufficient foreign-source petroleum is to encourage U.S. companies to continue to search for and develop these resources in diverse foreign areas.

What does this mean in terms of the provisions in H.R. 13270? Primarily, we think it means that the Congress ought to avoid making changes in U.S. tax laws relating to foreign income which would place obstacles in the way of U.S. companies participating in the growth of petroleum industry activities abroad. We are convinced that the changes in the House Bill would seriously impede the efforts of U.S. oil companies to participate fully in this growth.

Impact of U.S. tax system on competitiveness of U.S. oil operations abroad

Today the international oil industry is highly competitive. U.S. companies are continuously vying for position relative to foreign companies in all phases of activity—all the way from acquiring new producing concessions, up through refining and selling in final product markets. In this intense competition, cost advantages of particular companies are readily reflected in competitive bidding for new concession rights and in aggressive marketing tactics.

As confirmed by Assistant Secretary Cohen when he appeared before the Committee, foreign companies generally receive more favorable tax treatment from their home governments on their operations abroad than do American companies, and in many cases are totally exempt from taxation on their foreign income. In addition, many foreign oil companies also receive outright subsidies and other favored treatment from their home governments for foreign and domestic operations. Many of these benefits substantially reduce the costs of doing business and the associated risks, and are unavailable to American companies which compete with foreign companies receiving such benefits. For example, several foreign countries actually eliminate the risks of unsuccessful exploration by providing outright subsidies.

The significance and widespread use of incentives and cash subsidies for oil exploration by countries such as Australia, Germany, Japan, and the United Kingdom are described in Attachment I, "Summary of Incentives Granted by Foreign Governments in Regard to the Production of Oil and Gas Under Petroleum and/or Tax Laws." Germany has already adopted a system of interest-free loans to German nationals to finance the costs of foreign exploration, and if such exploration is unsuccessful, the loans need not be repaid. In addition, overseas losses can be offset against taxable income in Germany. The U.K. grants cash incentives for both domestic and overseas oil and gas exploration and development. The French government permits its national companies to deduct overseas exploration expenses against income derived within France. Japan, in addition to financial aid to Japanese companies exploring overseas, grants bonus exploration deductions and has committed itself to support exploration in Alaska, Southeast Asia, Africa, and the Persian Gulf. Many other consuming countries are intensifying efforts to encourage local ownership of foreign oil reserves, and additional incentives are now being contemplated. For example, the countries of the European Common Market are considering extending uniform tax incentives to national companies for foreign exploration. Also, government-owned or controlled companies from various foreign countries have entered the industry in increasing numbers and have proven to be aggressive competitors. Such state-owned or controlled companies frequently have political and monopoly advantages in their home markets and their actions are not necessarily determined by economic considerations.

Despite these differences, American oil companies have successfully achieved a leading position in the international oil industry. U.S. companies currently hold more than half of the world's known oil reserves outside the United States, account for roughly 60 per cent of Free World oil production, and own more than half of Free World refining facilities. It would be unfortunate if the Government of the United States took steps which in themselves could tip the scales in favor of our foreign competitors.

Foreign oil investments' contribution to balance of payments and other U.S. goals

Our country's national interest in providing for access to diverse and growing foreign sources of oil is sufficient reason, in itself, to reject the current tax proposals. However, there are other important reasons why these proposals should be rejected.

One is the important which these investments have for our balance of payments. The earnings generated by the more than $17 billion which U.S. companies have invested in foreign petroleum operations make a substantial positive contribution each year to the U.S. balance of payments and strength of the dollar. Last year, U.S. receipts in the form of income remitted from petroleum direct investments and royalties and fees related to these investments amounted to about $2.5 billion. In addition, these investments have directly resulted in substantial U.S. exports of capital equipment and other merchandise.

U.S. foreign investments in petroleum activities have also yielded a better-than-average contribution to our balance of payments. Petroleum investments have in each of the last three years contributed at least 44 percent of the income remitted to the U.S. from all direct investments abroad, while these investments represent a considerably smaller proportion—about 30 per cent—of the book value of all U.S. direct investments. Various estimates made by experts outside the petroleum industry suggest that, on the average, U.S. direct investments in foreign petroleum operations are fully returned in the balance of payments in from three to five years and result in substantial additional contributions to our payments position in subsequent years.

At a time of continuing international monetary uncertainities, with our balance of payments made weaker by the impact of persistent inflation in the United States on the competitiveness of U.S. production, it seems clearly unwise to take measures which would discourage the contribution U.S. petroleum investments abroad can make to our international payments strength.

The foreign petroleum investments of U.S. companies have not only served our national interest in securing foreign oil resources and benefited our international payments position, but also have contributed to other national objectives. Our economic welfare has been enhanced by the annual returns these investments have brought to the United States and by the substantial annual exports of U.S. goods and services they have generated. Moreover, the annual income received from these investments abroad has resulted in substantial additional U.S. tax revenues as this income is distributed to U.S. individual shareholders.

Another prominent U.S. objective in the postwar period has been to promote economic progress in the developing countries. U.S. petroleum companies have made a substantial contribution to progress in these areas by directly creating income and employment, and by providing host governments with substantial annual revenues which can be used to finance their countries' development. Moreover, American petroleum companies have frequently taken it upon themselves to build roads, hospitals, and schools, and to provide other facilities and services not directly related to their commercial operations.

In considering the provisions in the House Bill, we must recognize that a significant increase in the costs of doing business abroad—which could well result from the various proposed tax changes—would inevitably restrict the future contribution American oil companies could make to U.S. national security, to the balance of payments, and to other U.S. goals. A substantial impact is likely to be felt in the process of bidding for new concession rights abroad. Cost disadvantages for U.S. companies such as those which are entailed in the provisions of H.R. 13270 could have the effect of closing the door on U.S. companies' participation in future promising areas for petroleum production. These provisions would not only tend to discourage new U.S. petroleum investments abroad and thereby retard future growth in earnings for our balance of payments and economy, but could also have a depressing effect on the earnings of existing petroleum investments. In today's competitive world, an investment, once it is made, cannot be expected to continue to earn the same returns year after year without additional investment in expansion and modernization. Companies must keep roughly in line with the industry's growth and technological advances. In addition, of course, the foreign petroleum investments of U.S. companies must continue to be competitive with foreign petroleum companies and to earn returns at least commensurate with other U.S. investments abroad in order to continue to attract the capital which is required for their growth.

Principles of U.S. taxation on foreign-source income

Concerning foreign-source income, United States tax laws have traditionally sought to achieve equity among taxpayers and to prevent international double taxation. As noted earlier, many countries prevent international double taxation simply by imposing no taxes at all on the foreign income of their corporations which has already been subjected to foreign taxes. The United States, while recognizing the primary claim of the country of source to tax, has traditionally taxed the worldwide income of its citizens and corporations. Since 1918, the United States has sought to avoid international double taxation by means of the foreign tax credit. Thus, the United States has allowed credit against the U.S. tax liability on foreign-source income for income taxes paid to foreign governments on such income. In electing this method of avoiding international double taxation, the United States has long recognized that foreign income tax laws might very well differ in rate and method of computation from those of the United States. In arriving at the allowable credit, U.S. taxing concepts have been applied even if the foreign country does not necessarily follow such concepts in imposing its income taxes. That is, in taxing worldwide income, the same rules for determining income subject to tax have generally applied whether the business operations were conducted in the United States or abroad. While this approach has ensured that at least the U.S. income tax rate would apply, U.S. taxpayers have also been allowed the choice of computing their foreign tax credit on the basis of the per-country or the overall method of calculation. The general result has been that the burden of income taxes on foreign-source income has been either the foreign or U.S. tax rate, whichever is higher. Under this method, the foreign tax credit cannot exceed the U.S. tax which would be due on the foreign income. These concepts are basically sound and equitable, and should be continued.

To do otherwise could effectively shut off further U.S. foreign investments. As former Assistant Secretary of the Treasury Stanley S. Surrey has said:

"American investment would not proceed at all without the foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease." [1]

Sections 431 and 432 and Section 501(a) of H.R. 13270, if enacted, would violate the traditional principles followed by the United States of achieving tax equity and of avoiding international double taxation. A more detailed discussion of these provisions follows.

Section 501(a)

While Section 501(a) would reduce percentage depletion for oil and gas production in the United States, it would eliminate the allowance entirely for

[1] Source: *Hearings before the Committee on Foreign Relations, United States Senate, 90th Congress, 1st Session, on Tax Convention With Brazil, Executive Journal,* 1967, pp. 19–20.

foreign production. Of course, this provision involves outright discrimination against foreign versus domestic operations by U.S. petroleum companies. This contrasts to the existing equitable situation in which the U.S. generally does not require business operations abroad to pay more income taxes than the same operations would pay if they were conducted entirely in the United States. It would be particularly harsh on U.S. companies operating in Canada, whose oil industry is closely linked to the U.S. industry.

The various incentives and subsidies which foreign governments give to their petroleum companies for foreign production have already been noted and are described in Attachment I. In view of such practices on the part of foreign governments, the elimination of foreign depletion for U.S. companies could substantially reduce the ability of U.S. companies to compete with foreign companies in seeking to acquire new concession rights in foreign producing areas. In considering this provision we must recognize this fact and all its implications for the Unted States national interest.

Moreover, Assistant Secretary of the Treasury Cohen, in his appearance before the Committee, has already pointed out that enactment of Section 501(a) would do nothing more than penalize U.S. companies, with virtually no benefit to the U.S. Treasury:

". . . Our analysis of this provision indicates, in the light of our foreign tax credit provisions, that after a brief period it will probably result in foreign countries increasing their effective tax rates on income from oil and gas production to 'sponge up' any additional tax revenue otherwise accruing to the United States. Thus the denial of foreign depletion will increase the effective U.S. rate of tax on such income, which tax the foreign governments will then offset by increasing their rates. The end result will be that the U.S. taxpayer will pay additional tax to those countries, but no additional tax to the United States.

"For these reasons, the elimination of percentage depletion on foreign deposits of oil and gas is unlikely to increase U.S. revenues significantly, and will merely increase the burden of foreign taxes on U.S. businesses . . ."

Similar statements have been made in the past to the Congress by former Secretary of the Treasury C. Douglas Dillon [2] and former Deputy to the Secretary of the Treasury Dan Throop Smith.[3]

Thus, any increased tax revenue would be lost to the U.S. Treasury and U.S. balance of payments. In addition, the likely impact of the higher tax burden on U.S. oil companies' foreign activities would be to reduce earnings available for distribution to U.S. stockholders and thus would tend further to reduce Treasury tax revenues, owing to the reduction in taxable dividend income. This impact would tend to increase over time, as new investments were deterred by the greater burden of taxation.

The Treasury has recommended deleting the provision in Section 501(a) which would eliminate depletion on foreign oil and gas production. We strongly support the Treasury's recommendation.

Section 341

For companies which have elected the per-country basis for calculating their foreign tax credits, Section 431, in contrast to existing law, would not always allow full credit for foreign income taxes paid up to the amount of U.S. taxes which would otherwise be due on such income. In so doing, this provision would introduce new discrimination in U.S. tax laws affecting foreign-source income and would in some circumstances result in double taxation of foreign income. Therefore, we recommend that Section 431 be rejected.

In attempts to justify Section 431, it has been argued in the Ways and Means Committee report on H.R. 13270 that the current law provides a so-called "double tax benefit" to companies which incur initial losses in foreign activities and are able under the per-country foreign tax credit provision to reduce their U.S. taxable income in that year by the amount of such foreign losses. The first so-called tax "benefit" is that the taxpaying company is able to combine profits earned in the United States and abroad with losses incurred in the United States and abroad in determining taxable income. The reasonableness and appropriateness of combining profits and losses for tax purposes is accepted in the House-passed Bill, as it should be. This is a long-accepted and valid principle of taxation. The ability to combine profits and losses in the case of foreign and domestic

[2] "Statement on Hon. C. Douglas Dillon," *Hearings before the Committee on Ways and Means on the President's 1963 Tax Message, 88th Congress, 1st Session*, Feb. 7, 1963, p. 606.

[3] Dan Throop Smith, Letter dated May 6, 1958, to Harry F. Byrd, Chairman, Senate Finance Committee, on H.R. 8381, *Congressional Record*, August 11, 1958, p. 16923

operations is simply consistent with the U.S. principle of taxing the worldwide income of its citizens.

The second part of the so-called "double tax benefit," so the argument goes, is said to occur when operations turn profitable in the country in which the losses were incurred and the U.S. taxpayer is then allowed credit for the foreign taxes he actually pays on such income. This, of course, reflects the operation of the foreign tax credit, which is required in order to prevent international double taxation. Far from being a "double tax benefit," the credit for foreign taxes paid avoids the inequitable situation in which the taxpayer's income would be taxed twice.

Section 431 would deny to the taxpayer up to half of the credits currently allowable for foreign taxes actually paid until the Treasury effectively "recaptured" in actual U.S. tax revenues the amount of U.S. taxes which would be due on income equivalent to the earlier losses *if no foreign income taxes had been paid*. The point is, of course, that when foreign taxes are paid, any further taxation of income which has already been taxed at the U.S. rate, or higher, is double taxation which U.S. law has traditionally sought to avoid. The proposal would not eliminate a "double tax benefit," because there is no double tax benefit.

The following examples compare the results which occur under existing law with the results which would occur if Section 431 of the House-passed bill is enacted. The first example illustrates the results of the foreign country allows the taxpayer to carryover his losses and the second example if the foreign country does not allow any loss carryover.

EXAMPLE I—LOSS CARRYOVER ALLOWED BY COUNTRY A

For simplicity, assume that the taxpayer elects to claim the foreign tax credit in the year he incurs a foreign loss, that the U.S. and foreign tax rates are each 50%, and that foreign country A allows a loss carryover. The following example shows what would occur under both present law and section 431, assuming the financial results shown in Column 1:

	Income or (loss) (1)	Foreign tax (2)	U.S. tax—present law (3)	U.S. tax—sec. 431 (4)
1970:				
U.S. business	$1,000	0	$500	$500
Business in country A	(200)	0	(100)	(100)
Business in country B	1,000	$500	500	500
Total	1,800	500	900	900
Foreign tax credit—Country B			(500)	(500)
Net U.S. tax			400	400
1971:				
U.S. business	1,000	0	500	500
Business in country A	200	0	100	100
Business in country B	1,000	500	500	500
Total	2,200	500	1,100	1,100
Foreign tax credit—Country B			(500)	(500)
Net U.S. tax			600	600
1972:				
U.S. business	1,000	0	500	500
Business in country A	400	200	200	200
Business in Country B	1,000	500	500	500
Total	2,400	700	1,200	1,200
Foreign tax credit:				
For country A tax			(200)	[1] (150)
For country B tax			(500)	(500)
Net U.S. tax			500	550

[1] Note.—This result occurs because sec. 431 would reduce the amount of the allowable foreign tax credit in 1972 by 25 percent (limitation fraction of $300/2 400 instead of $400/2 400 times the U.S. tax of $1 200) which has the effect of doubling up on the taxation of the foreign source income in 1972. Although not clear from the committee report, statutory construction of sec. 431 appears to require a partial recapture of the 1970 loss incurred in country A in 1971 in the amount of $100 (not to exceed 50 percent of taxable income from country A in 1971 of $200) even though no tax was paid to country A in 1971. If this partial recapture is not made in 1971 the inequitable tax result shown here as occurring in 1972 would become twice as great resulting in a $100 additional U.S. tax instead of $50 as shown in the example.

Under present law, shown in column (3), the $200 loss in Country A in 1970 reduces the taxpayer's U.S. tax in 1970 by $100. In 1971, when $200 of income is earned in Country A, present law results in a U.S. tax of $100. Since Country A imposed no tax on this income, no foreign tax credit is available to satisfy the U.S. tax on this income. Thus, in countries which allow loss carryovers, when sufficient income is earned to offset the prior loss, the taxpayer automatically bears a U.S. tax liability equal to the earlier reduction in his U.S. taxes resulting from the loss. In 1972, when the taxpayer earns $400 of income in Country A and pays $200 of foreign income taxes, he owes no further U.S. taxes because of the foreign tax credit.

Under Section 431, shown in column (4), identical results occur in 1970 and 1971. However, in contrast to present law, in 1972 Section 431 would impose a further U.S. tax of $50 on the $400 income from Country A, thereby resulting in double taxation. As a result of this double taxation, the U.S. taxpayer in the example bears an effective income tax rate of 62.5 per cent on his 1972 income in Country A. Of course, the effective rate of tax which would result from the double taxation imposed by Section 431 can be much higher, or slightly lower than occurs in the example, depending on the amount of income earned in the year concerned. The point is that the inequitable result of double taxation occurs. Moreover, this occurs despite the fact that the earlier reduction in U.S. tax revenue resulting from the original loss was, in effect, "recaptured" by the United States when sufficient income was earned to offset the earlier loss.

EXAMPLE II—LOSS CARRYOVER NOT ALLOWED BY COUNTRY A

Assume the same facts as in Example I except that Country A does not allow a loss carryover.

	Income or (loss) (1)	Foreign tax (2)	U.S. tax—present law (3)	U.S. tax—sec. 431 (4)
1970:				
U.S. business	$1,000	0	$500	$500
Business in country A	(200)	0	(100)	(100)
Business in country B	1,000	$500	500	500
Total	1,800	500	900	900
Foreign tax credit—country B			(500)	(500)
Net U.S. tax			400	400
1971:				
U.S. business	1,000	0	500	500
Business in country A	200	100	100	100
Business in country B	1,000	500	500	500
Total	2,200	600	1,100	1,100
Foreign tax credit—country A			(100)	(50)
Foreign tax credit—country B			(500)	(500)
Net U.S. tax			500	550
1972:				
U.S. business	1,000	0	500	500
Business in country A	400	200	200	200
Business in country B	1,000	500	500	500
Total	2,400	700	1,200	1,200
Foreign tax credit:				
For country A tax			(200)	(150)
For country B tax			(500)	(500)
Net U.S. tax			500	550

The results in 1970 are identical to that in the first example, in which Country A allowed a foreign loss carryover. However, in 1971, since no loss carryover is allowed in Country A, the taxpayer pays a $100 tax to Country A. Present law permits the taxpayer to claim a tax credit for the taxes paid to Country A to the extent that the U.S. would have imposed a tax on such income had it been earned in the United States. Thus, the taxpayer is allowed a tax credit of $100 against his U.S. tax liability on the income from Country A. Also, in 1972, present law allows the taxpayer a $200 credit for income taxes paid on the $400 of income earned in Country A.

In contrast to the situation under present law, in which the taxpayer pays a tax rate of 50 per cent on his worldwide income, Section 431 would impose additional taxes in 1971 and 1972. Thus, under Section 431 the taxpayer would owe a U.S. tax of $50 in both 1971 and 1972 on the income from Country A, despite the fact that such income had already been taxed by Country A at the U.S. rate. As a result, in 1971 the taxpayer would bear an effective income tax rate of 75 per cent, and in 1972 a tax rate of 62.5 per cent on his income from Country A. As in Example I, the effective rates of the tax burden on this income in the years following the loss will depend on the amount of income earned in those years, and can be higher or lower than the rates shown.

Proponents of Section 431 would argue that the impact of double taxation such as occurs in 1971 and 1972 is justifiable because the taxpayer's loss in 1970 reduced his worldwide taxable income and, thus, his U.S. tax in 1970. Without the additional tax imposed by Section 431, the taxpayer would have a so-called "double benefit": (1) the recognition of the loss incurred in 1970 in determining total taxable income; and (2) the allowance of a tax credit for income taxes paid to a foreign government on subsequent income from that country.

It is difficult to see how taking a loss into account in determining worldwide taxable income can be considered to be an undue "benefit" to the taxpayer. Without recognition of the loss, taxable income would be overstated. In subsequent years, recognition of income taxes actually paid to a foreign country as legitimate credits against U.S. taxes imposed on the same foreign-source income is just, equitable, and essential to avoid the inequity of double taxation of the taxpayer's income.

In addition to the results described in the examples, if Section 431 is enacted unrelated projects in a country in which losses were incurred by a taxpayer could be burdened with double taxation as a result of the "recapture provisions" relating to losses incurred on earlier projects which never earned subsequent profits sufficient to offset those losses. This could affect completely unrelated projects undertaken many years later. For example, suppose a taxpayer initiated unsuccessful drilling activity in Country A in 1970, incurring substantial losses in the early years of the decade. Suppose that in 1980, while continuing to carry on small-scale exploration activity, the taxpayer decides that it would be economically attractive to establish a fertilizer plant in Country A, and expects during the first year of operations to earn profits. Under Section 431, even if the taxpayer would pay foreign taxes on his profit at the U.S. rate, he would nevertheless owe additional taxes to the U.S. Government on such income because of the prior losses from his drilling activities. The prospect of an additional tax burden on the fertilizer project, owing to losses on unrelated earlier operations, could well make an otherwise attractive investment uneconomic for the taxpayer.

Moreover, Section 431 would create tax liabilities relating to earlier losses even if the property which had given rise to the loss was subsequently expropriated by a foreign government without compensation. To illustrate, suppose a taxpayer experienced an operating loss of $50,000 in his branch operation in Country A in 1971, and in 1972 the government in Country A expropriated without providing any compensation for the $200,000 worth of property involved. Although the taxpayer would be allowed a tax deduction based on the cost of the property expropriated, Section 431 would require him to include in taxable income in 1971 an amount equal to the prior operating loss. Similarly, Section 431 would require the creation of taxable income equal to prior losses in cases in which property which gave rise to a foreign loss is subsequently abandoned or sold off at a loss. That is, while the taxpayer would be allowed to deduct the amount of the loss of property, he would also incur a tax liability for income equivalent to the prior loss.

Thus, the operation of Section 431 leads to the strange result that when a taxpayer incurs an operating loss followed by a loss of property, taxable income is somehow created out of thin air. In these situations it would have been advantageous if the properties had instead been destroyed by fire or windstorm, or some other casualty, since in such cases Section 431 would not require the creation of income subject to tax.

The operation of Section 431 would in some cases so severely discriminate against foreign activities as to preclude many new foreign ventures for U.S.

companies. Particularly risky foreign projects such as exploratory activities for foreign oil resources would be most seriously discouraged by this provision. Indeed, Section 431 would, over time, have the effect of denying existing deductions for intangible drilling costs to the extent these deductions resulted in a loss in a foreign country. Section 431 substantially adds to the deterrents in H.R. 13270 to the continued effective participation by U.S. oil companies in the international oil industry.

The Treasury supports this provision and recommends that it be extended to apply to situations in which there has been an overall foreign loss for a company which calculates its tax credit on the basis of the overall limitation. The proponents of Section 431 argue that the provision will increase revenues to the U.S. Treasury. It should be noted, however, that those who make this argument generally fail to take into account the impact these provisions would have on tax revenues resulting from taxes on U.S. dividend income. Profits from foreign ventures contribute significantly to the income and dividends of the companies involved, and such dividends are taxed in the hands of individual shareholders. To the extent U.S. companies find their ability to compete abroad impaired by the increased tax burden imposed by Section 431 they will lose investment opportunities to foreign competitors. Thus, U.S. corporate dividends will tend to diminish and, accordingly, U.S. tax revenues from dividend income will tend to decline.

For all the reasons outlined above, we urge that Section 431 be deleted from the House Bill.

Section 432

Section 432 would introduce a special limitation on the amount of credits allowed for foreign income taxes paid in connection with foreign mineral producing activities. This provision is highly discriminatory against extractive industries and apparently reflects faulty analysis of the taxes incurred on petroleum operations abroad as well as a failure to recognize the integrated nature of these operations. We recommend that it be rejected.

It has been suggested that the income taxes paid by U.S. petroleum companies in some foreign producing countries must contain an element of "royalty" in them, since the income tax rates in such countries are sometimes higher than the U.S. rate, or higher than the rate applying to other industries in that country. However, those who have argued that income taxes in petroleum-producing countries contain an element of royalty (for which credits against U.S. taxes are not allowed) are apparently not aware that royalty payments in these countries are generally as high as, and in some cases considerably higher than, royalties paid on production in the United States. For example, in the case of Venezuela, the effective rate of royalty on gross producing income exceeds 25 per cent, compared to the 12½ to 16⅔ per cent the U.S. industry generally pays on gross producing income in the United States.

Moreover, the fact that both royalties and income taxes are paid to the same government—on the one hand as the owner of the property from which the minerals are produced, and, on the other hand, as the authority levying a tax on the income resulting from such production—does not alter the nature of either payment. Both royalties and income taxes relating to petroleum production are paid to the Federal and State governments in the United States, and to foreign governments, including Canada, Australia, the United Kingdom, and the Netherlands, as well as countries in Asia and Africa. It is clearly possible to distinguish between royalties and income tax payments to these countries.

As Assistant Secretary Cohen expressed the Treasury's view, in discussing Section 432:

"The Administration supports, in part, the effect of this second provision. However, while we recognize the hidden royalty problem at which the House Bill is directed, we do not feel that the bill provides an equitable solution to that problem. On further examination of the tax and royalty structure applicable to the international minerals industry, we do not feel that it is proper to characterize all foreign taxes on mineral income in excess of U.S. taxes on such income as disguised royalties. It is impossible to ascertain the extent to which income taxes in any particular country are a substitute for royalties, and in many cases the foreign country receives royalty payments which are even greater than royalties customarily paid in the United States. Also, foreign countries frequently impose income tax on non-mineral income, as well as on mineral income, at a rate in excess of the U.S. rate.

"If, then, this separate limitation in the bill regarding mineral income is not justified on the ground that any foreign tax in excess of the effective U.S. tax on mineral income is a royalty, it works unfairly for mineral companies as compared to all other U.S. taxpayers with foreign operations. It completely denies mineral companies the opportunity, available to other taxpayers, to average the excess of foreign tax over U.S. tax on mineral income against any excess of U.S. tax over foreign tax on their other foreign income. This result occurs even though the foreign tax on the mineral income is at a reasonable rate judged by world standards and even though such averaging is precisely the purpose of the over-all limitation."

In our opinion, the Treasury is correct in urging rejection of Section 432 as it now stands, since it would, in effect, unfairly deny the use of the overall credit to the mineral industry. The Treasury has recommended in lieu of Section 432 that excess credits for foreign taxes paid on mineral income resulting from the allowance of U.S. percentage depletion which Treasury has recommended be reinstated on foreign production not be available to be applied against other income. The Treasury has also said that a similar rule now applies in the case of Western Hemisphere Trade Corporations. We believe that this proposal should be studied carefully.

The Treasury has also expressed a broader concern about high foreign tax rates and noted that, apart from percentage depletion, it could be provided for the mineral industry that excess credits resulting from foreign income tax rates higher than 60 percent not be available to be used against other income. However, as the Treasury has stated, such singling out of the mineral industry cannot be justified on the grounds that high foreign tax rates contain disguised royalties. Therefore, Treasury has decided to study the question of high foreign tax rates in a general context, as they apply to all industries. We agree with the Treasury that there is no justification for singling out the mineral industry for discriminatory treatment in this area. However, in our opinion, there is also no justification for invading the overall foreign tax credit limitation as it applies to all industries, such as a generalized limitation with respect to credits resulting from foreign tax rates in excess of 60 percent would do.

Section 432 of H.R. 13270 would go much further than this for the mineral industry by preventing mineral companies on the overall foreign tax credit limitation basis from using any excess tax credits from mineral producing activities abroad. Thus, Section 432 would separate for U.S. tax purposes a part of the foreign petroleum industry production which is economically inseparable from activities such as refining, transporting and marketing this production. Investments in foreign oil producing activities are closely linked to investments in refineries, pipelines, tankers, and other distribution facilities. For example, since the beginning of 1960 my Company alone has spent about $1.5 billion to add a crude oil producing capacity abroad. This oil was, and is, destined primarily for markets outside the United States—in Western Europe, Latin America, Asia, Africa, and the Far East. But without heavy further investments by Jersey Standard in refineries, pipelines, tankers, and other distribution facilities to serve these markets, we simply could not have justified such large investments in additional producing capacity. An international oil company is a closely tied network of oil trade which simply cannot be untied or separated into segments. To attempt to do so contradicts economic fact.

In enacting the overall limitation for purposes of the foreign tax credit in 1960, the Congress stated in House Report No. 1358, 86th Congress, 2nd Session, page 866:

"In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation."

Thus, the existing option available to U.S. companies to elect the "overall" basis for determining the credit for foreign taxes paid results from deliberate Congressional action, in which the Treasury concurred. In this connection, it may be recalled that former Assistant Secretary of the Treasury for Tax Policy Stanley S. Surrey praised such action by the Congress in the 1962 Revenue Act, by noting that the Act:

". . . sets a precedent for looking at the foreign activities of a U.S. corporation on a consolidated basis, as if together they comprised a single entity. In this respect the tax law is beginning to recognize the 'international corporation' and to grapple with the technical tax problems which it involves." [4]

As noted in the House Report cited above the introduction of the overall limitation was based on the fact that many U.S. companies regard their foreign activities as an integrated operation outside the United States. Accordingly, in such cases it is appropriate, and would reflect economic reality, to permit such companies to compute the foreign tax credit on the basis of income from all sources outside the United States rather than a country-by-country basis. As explained previously, the integrated nature of the international oil industry makes it particularly appropriate to allow U.S. oil companies to elect the overall foreign tax credit limitation, and thereby average together the high and low rates of tax paid on operations in all foreign areas. Notwithstanding this fact, Section 432 effectively would deny the use of the overall concept to the mineral industry. As was noted by Secretary Cohen before this Committee early last month, to introduce a separate limitation for tax credits on income from mineral production would effectively deny to mineral companies the option under existing law for companies to elect to calculate their foreign tax credit on the basis of the overall limitation, while permitting all other industries to continue to elect the overall basis. Such discrimination is clearly unjust and unwarranted.

Moreover, the proposed limitation in Section 432 would have the effect of double taxation of the income from integrated petroleum activities abroad. Rather than allowing the averaging of the high and low tax rates, Section 432 would seek out individual parts of a taxpayer's income in low-tax countries and increase the tax to the U.S. level. In so doing, this provision would effectively require mineral business operations abroad to pay more income taxes than the same operations would pay if conduced wholly within the United States. However, the end result would be a net gain for the treasuries of foreign governments with no significant increase in revenues for the United States. This would occur because foreign governments with lower income tax rates would recognize that if they increased their taxes on the American mineral industry abroad, such taxes would be creditable against U.S. taxes on the same foreign income.

Conclusions

In our opinion, Sections 501(a), 431, and 432 of H.R. 13270 ought to be rejected. By increasing the tax burden on U.S. petroleum companies' operations abroad, the provisions contained in these sections could seriously impair the ability of U.S. companies to compete effectively with foreign companies in the international oil industry. This could affect U.S. companies' participation in all phases of the industry, but the most severe impact is likely to be felt on the ability of U.S. companies to obtain concession rights in new producing areas.

The national security interest of the United States requires that our country have ready acess to growing and diverse foreign sources of oil to meet our expanding economic and military needs for energy. The provisions in H.R. 13270 relating to the foreign activities of U.S. petroleum companies would place new obstacles in the way of U.S. companies participating in the future growth of the industry abroad, and thus would run counter to our national security interest. Moreover, by discouraging the foreign investments of U.S. petroleum companies and delivering investment opportunities to foreign competitors, the provisions would be detrimental to our balance of payments and general economic welfare. Finally, the provisions are inequitable, would result in double taxation, and are unlikely to produce a significant amount of revenue for the United States.

Sections 501(a), 431, and 432 all would discriminate against foreign-source income, and would unfairly increase the tax burden on U.S. investors who have made substantial foreign investments on the basis of existing tax law. Section 501(a) would discriminate against the foreign activities of U.S. petroleum companies by denying them comparable tax treatment to operations conducted in the United States. Section 431 would double-tax individual parts of a taxpayer's income, while Section 432 would introduce international double taxation on the integrated petroleum industry operations abroad by denying to the mineral industry alone the effective use of the overall basis for applying the foreign tax credit. All these provisions would seriously depart from valid and long-standing principles of tax equity. We strongly urge that they be rejected.

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[4] Remarks by the Honorable Stanley S. Surrey, Assistant Secretary of the Treasury, before the Tax Institute Symposium, Washington, D.C., October 25, 1962.

ATTACHMENT I

SUMMARY OF INCENTIVES GRANTED BY FOREIGN GOVERNMENTS IN REGARD TO THE PRODUCTION OF OIL AND GAS UNDER PETROLEUM AND/OR TAX LAWS

Argentina

Immediate deduction is allowed for exploration costs as well as amortization thereof. An option is available to deduct exploration expenses and normal depreciation on capital assets against non-petroleum activities.

Australia

Recovery of expenditures.—A taxpayer is permitted to recover allowable capital expenditures in regard to exploration and producing activities before any production income becomes subject to income tax. This provision accumulates expenditures for formation, exploration/development and production as deductions against future income from the sale of petroleum production. Income tax is thus postponed until the deductions have been fully offset against producing sales. A petroleum exploration company is allowed to transfer the tax deduction for any producing or exploration expenditures from itself to its shareholders. In this way, the shareholder can claim the deduction for the stock investment in a petroleum exploration company against current taxable income and the deferred deduction of the exploration company is correspondingly reduced.

Partial additional deduction for investment.—A deduction for ⅓ of the "calls" on shares to the stockholder investing in the exploration venture is allowed. Since the exploration company may claim a tax deduction for its expenditures, this will result in an aggregate deduction of 133⅓% between the company and its shareholders.

Direct subsidies.—Subsidies are also used to create favorable conditions for petroleum exploration activities. Originally limited to a subsidy of ½ the cost of a company's approved-stratigraphic drilling program; now extended to include off structure drilling, detailed structure drilling, borehole surveys, and geophysical surveys employing magnetic, seismic, gravimetric or other physical methods of obtaining petroleum exploration information. Both past and future subsidies are not taxable, but the taxpayer's deduction for exploration expenditures has to be reduced by the amount of subsidy received. The government now pays up to 30% of the cost of all geophysical surveys and test drilling operations. In the case of stratigraphic drilling the limit is 40%.

Belgium

Allows producers a tax-free reserve limited to 50% of the taxable profits from production. Such reserves must be reinvested within 5 years.

British Honduras

Allows percentage depletion of 27½% of gross income limited to 50% of net petroleum income after royalties but before depletion. Intangible drilling costs are deductible when incurred, limited to 50% of net petroleum income after royalties but before depletion.

Canada

Allows percentage depletion at 33⅓% of overall profits. All drilling, exploration and general operating costs on a company-wide basis must be deducted before depletion is computed.

Colombia

Allows normal percentage depletion of 10% of the gross value of production less any royalties or participations, limited to 35% of net income before depletion. In addition, a special depletion allowance, computed on the same base, of 18% in the East and Southeast Region, and 15% in the rest of the country, is also allowed. The total of normal and special depletion is limited to 50% of net taxable income in the East and Southeast Region and to 45% in the rest of the country. Amounts allowed as special depletion must be reinvested within three years in petroleum related facilities. Failure to reinvest results in their restoration to taxable income, but over-investment may be carried forward to apply against future reinvestment obligations.

France

Allows producers a reserve equal to 27½% of the gross value at the wellhead of the crude oil extracted. This reserve is limited to 50% of the net profit from production and from the first stage of processing in the producer's own refineries. For the tax exemption to be retained such amounts must be reinvested within 5 years, either in the way of fixed assets or research work for new discoveries of oil or gas, or by making investments in certain companies approved by the government. If not reinvested within this time limit, the reserve is required to be restored to the taxable profits of the fiscal year during which such 5 year period expires, and taxed as ordinary income.

Germany

German (domestic) oil companies operating outside Germany could obtain through December 31, 1968 low interest loans in amounts of up to 75% of the costs of exploration. Such loans were repayable only when commercial production was obtained. Exploration for or production of oil during the years 1959 to 1962 was a prerequisite. There is a new government incentive for foreign operations which was signed on July 7, 1969, effective for the years 1969 through 1974. Under the new proposal a total of DM 575 million will be allocated under a loan scheme. Loans will be granted up to 75% of exploration expenditures and if there is no discovery, no repayment will be required. Even with discovery, up to 50% of the loan can be waived under certain circumstances. If the financial situation warrants it, the plan contemplates a non-repayable contribution of up to 30% of the costs of acquiring a productive field or shares in a producing company. To be eligible under this new plan, the company must be domiciled in Germany and have produced petroleum in Germany or been processing petroleum within Germany prior to January 1, 1969. Loans will not be granted if the enterprise can reasonably be expected to finance itself. However, it is expected that if a group of the major German-controlled companies form a new company to explore overseas, this new company will not be considered able to finance itself. Until January 1, 1970, oil and gas companies are permitted to write off drilling costs, geological and geophysical expenditures, dry holes, etc., immediately against other income, whether a branch or subsidiary is used. An oil company can also write down its investment in a foreign subsidiary. When production is achieved the investment must be restored, but this restoration can be written off on a very liberal basis. Presumably this legislation will be extended.

Guatemala

Allow percentage depletion of 27½% of gross income, limited to 50% of net income. Exploration and intangible drilling costs can be expensed. Losses can be carried forward indefinitely.

Guyana

Allows percentage depletion and deduction of intangible drilling costs at a "reasonable" level as established by the Commissioner.

Honduras

Allows percentage depletion of 25% of gross production, limited to 50% of net taxable profits. Exploration expenses as well as intangible drilling costs can be expensed. Losses can be carried forward for ten years.

Israel

Allows percentage depletion of 27½% of gross income, limited to 50% of net income.

Japan

Allows percentage depletion for companies conducting petroleum exploration, subject to a recapture to the extent that, within a 3-year period, an amount equivalent to the deduction has not been invested in further exploration. The amount is 15% of sales revenue, limited to 50% of net income. A current deduction of intangible drilling and development costs for unsuccessful wells is also provided. These incentives apply to both domestic and overseas exploration.

Overseas incentive.—The government has organized the Petroleum Development Public Corporation (PDPC) as a government-owned entity for the purpose of channeling government funds into exploration and production in order to promote the development of petroleum resources and to ensure stablized supplies of petroleum.

The PDPC accomplishes these objectives by:

(1) Making investments and loans necessary for petroleum exploration in overseas areas.

(2) Guaranteeing debt resulting from loans necessary for overseas petroleum exploration and production,

(3) Leasing equipment required for oil exploration, and

(4) Giving technological guidance on oil exploration and production.

The loans referred to in (1) are extended on favorable terms and repayment is required only if the venture financed is successful. Loans amounts may be as high as 50% of the cost of the undertaking, and joint exploration ventures by Japanese and foreign companies, in which the Japanese interest is at least 50%, may also receive these benefits. To date, the PDPC has committed itself to extend financial support to exploration ventures in Alaska, Southeast Asia, and the Persian gulf.

Domestic incentives. Presently, the government is in the process of developing a policy to actively encourage development of domestic oil and gas reserves. There is in effect a duty rebate system for certain offtakers of indigenous crude. There has been pressure on the government to extend the above PDPC incentives to domestic production, consequently, the government is now reviewing this possibility.

Nicaragua

Allows percentage depletion of 27½% of wellhead value less royalties, limited to 50% of net taxable income before depletion. Intangible drilling costs and dry hole costs are deductible once production is attained. Losses may be carried forward ten years.

Nigeria

Exploration losses, intangible drilling costs and dry holes can be expensed. Losses may be carried forward indefinitely.

Norway

The government may grant companies engaged in the exploration and exploitation of offshore oil and gas deposits the right to carry losses forward over a 15-year period rather than the normal 10-year period.

Pakistan

Allows percentage depletion at the rate of 15% of the wellhead value, subject to a maximum of 50% of net income.

Peru

Allows percentage depletion from 15% to 27½% of the gross value of production (adjusted for transportation in certain areas) depending on whether a national or foreign company is involved and the region in which production is located. A foreign company with production in the Coastal Region is limited to 50% of net profit after deducting depletion and the 20% minimum advance payment of income tax. All others are limited to 50% of net profit before deduction of depletion and the advance payment of income tax. Deduction for intangible drilling costs is also allowable.

Philippine Republic

Allows percentage depletion of 27½% based on gross income, after an amount equal to any rents or royalties paid or incurred in respect to the property has been deducted.

Sabah

Allows percentage depletion at rates deemed reasonable by the Commissioner.

Spain

Allows percentage depletion of 25% of the field value of production less royalties, but limited to 40% of the net profit before deducting depletion: Similar rules apply in the Spanish Sahara.

St. Maarten

Allows percentage depletion at rates deemed reasonable by the Commissioner.

Trinidad and Tobago

Allows percentage depletion of 20% of the gross value of production of submarine wells limited to 40% of income without the deduction of certain specified allowances.

Turkey

Allows percentage depletion of 27½% of the gross income from production after deducting rentals and royalties, limited to 50% of net income before deduction of depletion.

United Kingdom

Cash grants of 20% (40% in certain onshore areas) for oil and gas operations onshore and offshore are available generally as follows:

(1) Geological and geophysical expenses are usually eligible for grant except for the cost of general surveys to determine whether or not to begin exploration in an area.

(2) Lease acquisition costs are not eligible.

(3) Exploration, evaluation and production drilling costs qualify.

(4) Production equipment, certain pipelines and drilling platforms including overheads qualify.

In effect all exploration and drilling expenses (not in excess of investment grants) incurred prior to proving reserves may be expensed. Thereafter until production is achieved, both tangible and intangible drilling costs are capitalized and amortized on a unit of production basis. After production is achieved, tangible costs are still capitalized and amortized, but intangible costs are expensed. Losses may be carried forward for an unlimited number of years. All of the foregoing items that require capitalization must be so treated because only an item that is capitalized is eligible for an investment grant. If for any reason an investment grant is not received, such items may be expensed.

STATEMENT OF ROBERT G. DUNLOP, PRESIDENT, SUN OIL COMPANY, PHILADELPHIA, PA., AMERICAN PETROLEUM INSTITUTE; MID-CONTINENT OIL & GAS ASSOCIATION; AND WESTERN OIL AND GAS ASSOCIATION

SUMMARY

1. The United States economy is heavily dependent upon petroleum energy; oil and gas today provide nearly three-fourths of all energy consumed in this country.

2. Assured supplies of petroleum are vital to the national security of the United States.

3. With present tax incentives, the domestic petroleum industry has met this country's essential petroleum needs.

4. Present tax and other incentives have enabled the industry to develop a reserve producing capacity amounting to 3,000,000 barrels daily in 1968.

5. Similarly, the United States today has a spare producing capacity—producible and deliverable with existing facilities—of 1,000,000 barrels daily, which is available to meet emergency needs of this country and its Allies.

6. With existing tax incentives, the industry has made oil and gas available to consumers at reasonable prices.

7. Since it is based on production, the depletion provision is a particularly effective incentive for research leading to technological improvement; as such it has contributed significantly to broadening the nation's petroleum resource base.

8. Existing tax incentives have contributed significantly to improving the international payments balance of the United States and to world economic progress.

9. Tax incentives have contributed to the conservation of natural resources by encouraging the use of marginal oil.

10. The petroleum industry earns only average profits on investment.

11. The petroleum industry carries an overall tax burden equivalent to or exceeding that borne by other industries.

12. The combination of sharply rising costs and modestly rising prices is limiting funds available for investment; reserves of oil and gas declined both relatively and absolutely in 1968.

13. Federal control of natural gas well-head prices is partially offsetting the effect of tax incentives and creating a serious supply problem for the future.

14. Increased taxes would likely result either in higher petroleum prices or in reduced investment; neither alternative is desirable.

15. Complete elimination of tax incentives would make the United States heavily dependent on foreign oil; that dependency would range up to 48 to 58 per cent of supplies.

16. This dependency could very well involve this country in a Middle East conflict, through our attempting to insure stability in the area.
17. Contrary to popular notions today, the United States is not running out of oil. Neither is it indicated that Alaska will produce enough additional oil to meet our future needs.

STATEMENT

I am Robert G. Dunlop, president of Sun Oil Company, Philadelphia, Pa. My appearance today is on behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association and the Western Oil and Gas Association.

I will attempt to give you an over-view of the present petroleum situation in the United States and of the likely impact of proposed tax changes on that situation. Appearing with me are Mr. William Spencer, executive vice president of the First National City Bank of New York, who will discuss future petroleum requirements and capital investment needs; Mr. George V. Myers, executive vice president, Standard Oil Company (Indiana), who will evaluate the impact of the proposed tax changes on domestic operations; and Mr. Emilio G. Collado, executive vice president of Standard Oil Company (New Jersey) who will close our presentation with a discussion of the tax treatment of foreign petroleum operations.

My colleagues and I appreciate this opportunity to present the petroleum industry's views on proposed tax changes for oil and natural gas. We feel strongly that this Committee's decisions on petroleum tax policies will significantly affect the Nation's future economic progress and its security. Accordingly, we feel that it is vitally important that the Committee's decisions be based on a comprehensive review of the effect of the proposed changes on our Nation and all of its citizens. It is our intent to contribute to this review by providing you with pertinent background information on the present petroleum situation and how it would be affected by the tax changes now under consideration.

In providing an over-view, I will attempt to define the role of tax incentives in the Nation's petroleum progress; to place the industry's tax payments, prices and profits into perspective; to discuss the relevance of petroleum tax policy to national security; to describe the present status of the industry; and to look at the impact of the tax proposals on the United States petroleum supply position.

First, however, I would like to state the industry's basic position on proposed changes in tax policy. It is this. Our experiences as oil men demonstrates that tax incentives provided by the Congress in present law have very effectively achieved the purpose for which they were created: to provide an incentive for development of our petroleum resources. That our resources have, in fact, been effectively developed is a matter of record—a record of which we in the industry are indeed proud.

We observe two kinds of pressure being applied for a reduction in petroleum tax incentives. One is the pressure of emotional argument for boosting taxes on oil companies, come what may. The second is a more reasoned approach, recognizing the need for incentives but questioning whether the present level is necessary.

The facts of the situation appear to be of little interest to those who have been advancing the emotional arguments. But we are hopeful that the facts will be of paramount importance to those who are sincerely interested in reaching tax policy decisions that will be in the long-run best interests of the people of the United States.

We seek to be open-minded. We are not blindly opposed to change. If petroleum tax policy changes can be demonstrated to be in the best interests of the American public, we will surely not oppose them. But we strongly oppose change based on emotion rather than reason—change which is inimical to the progress of this Nation and to its security.

PETROLEUM ENERGY IN THE UNITED STATES

Against that background, I want first to look with you at the role of petroleum energy in the United States today. I submit that it would not be overstating the case to say that petroleum is the virtual lifeblood of this country. The Department of the Interior has aptly summed up the Nation's heavy dependence upon oil and natural gas in these words:

> "The importance of petroleum to the national life of the United States at this particular moment in history is abundantly in evidence. It supplies

nearly three-fourths of all energy consumed. Virtually all movement of goods and people depend on it. The Armed Forces would be immobilized without it. Countless industrial processes employ it exclusively, and nine-tenths of all space-heating is provided by it. And quite apart from its use as a fuel, petroleum forms the base for 88 percent of all organic chemicals manufactured in the United States."

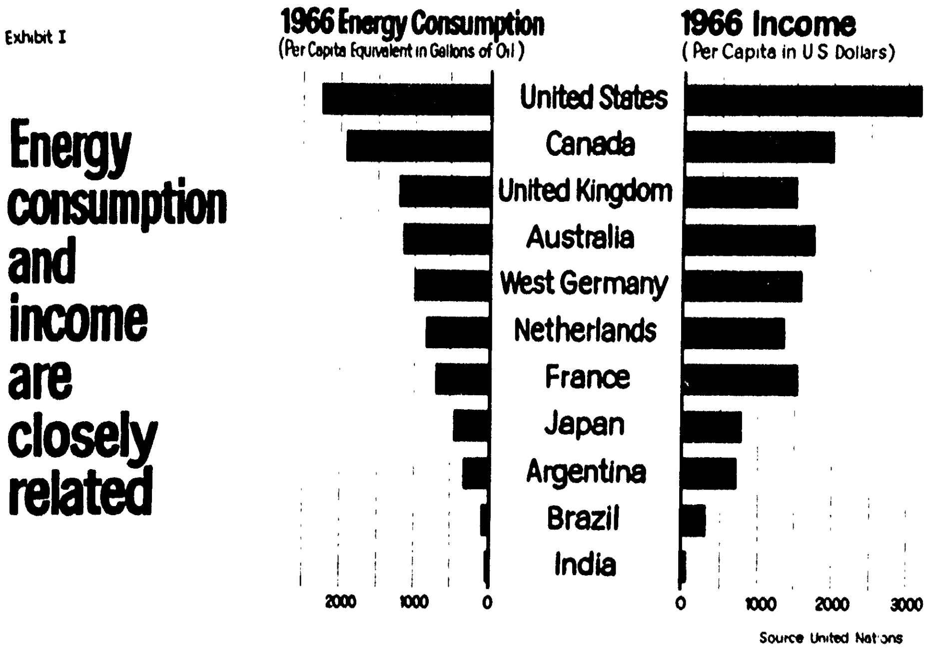
I have taken a moment to include that quotation because I feel that it points up sharply why we are here today. Petroleum is vital to our country—so vital that the Nation could not exist today as we know it without adequate supplies of oil and natural gas.

The industrial revolution which is at the base of our prosperity could just as accurately be characterized as an energy revolution. Our ability to substitute inanimate energy for muscle power has made possible the tremendous increase in per capita production which is the essential measure of economic development.

The correlation between energy consumption and income is one of the significant facts of modern life. (See Exhibit I.)

Petroleum is also essential to our defense capability, although in this age of nuclear weapons some observers seriously challenge this view. I would remind those challengers that, fortunately, the nations of the world have so far avoided nuclear war as a means of solving differences. And we all live in the hope that they will continue to do so. Conventional warfare, on the other hand, is likely to be with us for the foreseeable future. So petroleum is now, and will continue to be, vital to our national security.

Exhibit I



Although surprising to many, the truth is that petroleum is becoming increasingly important to our defense capability. In 1968, defense procurement of petroleum per man under arms *was twice the peak World War II level*—even though the fighting in progress last year was restricted to a very limited geographic area.

The Department of Defense has put it this way:

"The part that oil plays in the defense posture of the United States is vitally important. It is a strategic material and one of the few items that is absolutely essential and foremost in the minds of military commanders. Along with weapons and ammunition, the needs of petroleum get the most attention."

In my view, these facts add to an inescapable conclusion: The future of the United States as we know it is vitally dependent upon assured supplies of oil. Realistically, we have only two routes to travel in obtaining oil:

(1) maintaining a strong domestic industry capable of meeting our essential needs, or

(2) turning increasingly to foreign supplies and, ultimately, becoming dependent upon those less secure foreign sources.

PETROLEUM DEVELOPMENTS UNDER EXISTING TAX POLICIES

Up through the present day we have chosen to travel the first route, seeking to provide the incentives necessary to assure the continuance of a strong domestic petroleum industry capable of meeting the essential oil and gas needs of the Nation.

Was this a wise course of action?

Petroleum needs fully met

The record affirms that it was. For under past and present policies the United States petroleum industry has historically met the petroleum supply needs of this Nation and at the same time contributed immeasurably to the needs of our friends and allies. I need not recount to this Committee the major supply crises we have successfully met in the past.

It would perhaps be of interest and value, however, to show by example how petroleum tax incentives, working in conjunction with other incentives, have contributed to the development of our petroleum resources.

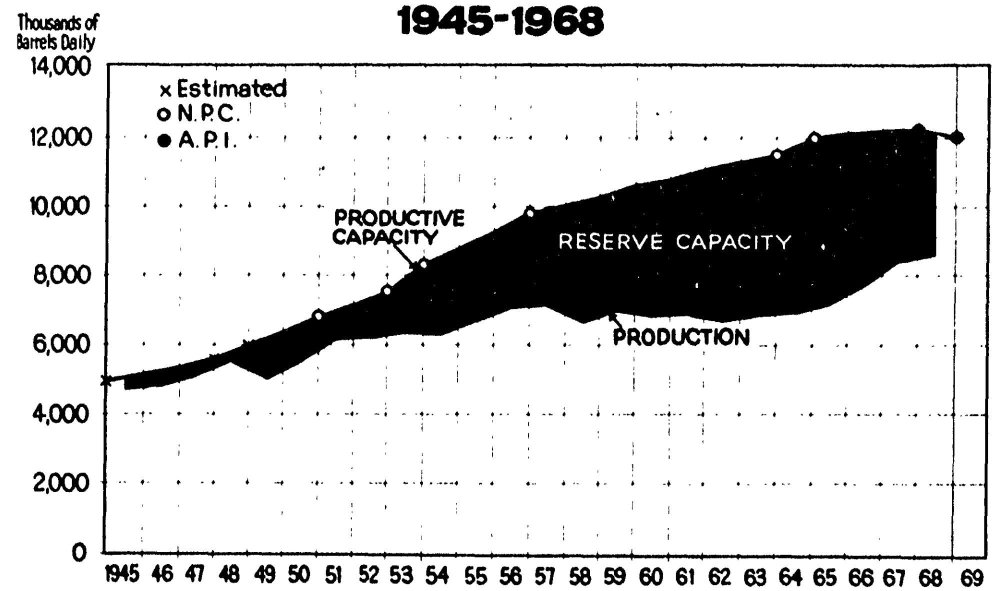
At the close of World War II, the heavy war-time drain on United States petroleum supplies had resulted in a situation where productive capacity was barely equal to demand.

The tax incentives, together with the thrust of rising prices during the late 1940's, enabled the industry steadily to improve the supply situation. By 1955, as shown in Exhibit II, we had reserve capacity of more than 2,000,000 barrels daily. In 1968, reserve capacity was 3,000,000 barrels daily.

Exhibit II

RESERVE CRUDE OIL PRODUCTIVE CAPACITY

1945-1968



I suggest that this is a dramatic demonstration of the role played by the depletion provision and other incentives in helping to assure adequate supplies of petroleum for the United States.

To carry the discussion one step further, we might with profit examine our present available spare producing capacity in the light of potential requirements. I am referring now to deliverable capacity—that capacity which can be produced and transported with existing facilities.

I can best demonstrate this by posing a hypothetical situation. Assume for a moment a Middle East war in which the United States, Canada, Western Europe and Japan would be denied Arab bloc oil—that is, all oil from North Africa and the Middle East with the exception of Iran.

Assume also that the United States, Canada, Latin America and Iran choose to supply oil to the maximum of their ability to Western Europe and Japan, which are heavily dependent on Arab bloc oil.

First, what would be the oil supply position of the United States and Canada in this hypothetical situation? And, second, what would be the combined position of the United States, Canada, Western Europe and Japan?

A table demonstrating the supplies that could be made available in relation to requirements is attached as Exhibit III.

In response to question one, the figures show that the United States and Canada would lose 400,000 barrels daily of supply from the Arab Bloc. However, our country and Canada have a combined spare capacity of some 1,200,000 barrels daily, and could cover that loss.

EXHIBIT III.—EFFECT OF LOSS OF ARAB BLOC SOURCES OF CRUDE OIL FOR THE UNITED STATES, WESTERN EUROPE, AND JAPAN

[In thousands of barrels per day]

	United States and Canada	Western Europe and Japan	Combined
1968 requirements	14,700	12,700	27,400
Available from—			
Domestic production	11,700	400	12,100
Present production from non-Arab sources	2,600	3,000	5,600
Spare capacity:			
United States	200	800	1,000
Canada	200		200
Iran and Latin America		1,100	1,100
Total available sources	14,700	5,300	20,000
Shortage		[1] 7,400	7,400
Total	14,700	12,700	27,400
1968 imports from arab sources	400	9,300	9,700

[1] If the United States were to share the burden, there would be a shortage in the United States and a correspondingly lower shortage in Western Europe and Japan.

In regard to question two, by making the best possible use of existing pipeline connections between the U.S. and Canada, we would have, together, remaining spare capacity of only 800,000 barrels daily. Assuming that we made this oil available, and that Latin America and Iran similarly made their spare capacity available, Western Europe and Japan would then be short 7,400,000 barrels daily, or 58 per cent of their needs. If the U.S. were to share this burden, there would then be a shortage in the U.S. and a correspondingly smaller shortage in Western Europe and Japan.

This example clearly demonstrates two important points. First, the United States, with its total deliverable capacity of 10,000,000 barrels daily, is the bulwark of Western oil supply. And, second, even with the spare capacity now available in the United States, there is a significant gap between oil supply and normal requirements in the West. We can permit that gap to continue to grow only at our peril.

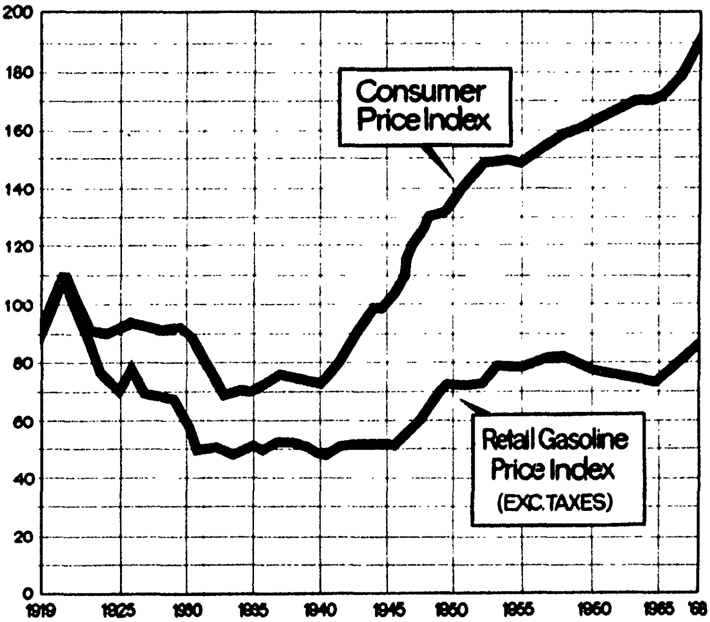
Petroleum Provided at Reasonable Prices

In addition to stimulating the development of adequate supplies of petroleum to meet our domestic needs, existing tax policies have helped to make that oil and gas available at reasonable prices to consumers. In terms of real purchasing power, the average price of crude oil has declined in the neighborhood of 20 per cent since 1926. Price comparisons over a more recent period show that since 1957–59 the wholesale price index for crude oil has risen just five per cent while the index for all commodities has increased by 13 per cent.

Gasoline prices, excluding direct taxes, are up only 10 per cent, or approximately two cents per gallon, since 1926. Over the same period, the consumer price index has doubled. Again, over a more recent period, the price of gasoline has advanced approximately 10 per cent since 1957–59 while consumer prices generally went up some 28 per cent. (See Exhibit IV.)

Exhibit IV

Price of gasoline is low



SOURCE: Price Index Bureau of Labor Statistics Gasoline Prices Tax Economics Bulletin of API

Technological Advances Benefit the Nation

I also want to point out that tax incentive have helped to create benefits for the Nation over and above the development of adequate supplies of petroleum at favorable prices.

The depletion provision, for example, through encouraging investment in the industry and helping to keep it strong, has spurred technological advances in finding and recovering America's oil and gas. The economic impact of these advances has been substantial.

It should be emphasized that percentage depletion is a particularly effective incentive for research leading to technological improvement, since it is based on production. A direct subsidy to exploratory drilling might stimulate that activity, but percentage depletion stimulates *both* exploration and technological advance after discovery. Percentage depletion rewards the successful explorer in proportion to the amount of oil he finds and produces—and hence in proportion to his contribution to the national interest. After successful exploration, it rewards successful research designed to increase producibility of the reserves discovered. It applies in neither case in the event of failure because it becomes effective only when oil is produced. In contrast, a subsidy applies regardless of failure or success.

In exploration technology, improved drilling capabilities have enabled the industry to recover oil and gas at depths that were formerly impossible to drill. In 1930, the deepest well yet drilled went down only slightly more than 9,200 feet. Today the industry is drilling below 25,000 feet.

On another front, offshore drilling in the United States was negligible until the latter half of the 1940's. Today, in contrast, offshore production accounts for some 10 per cent of oil output and 12 per cent of gas output, and the offshore search is one of our brightest prospects for the future. Again, improved technology was the key.

To cite one more example, improved exploratory and drilling know-how is playing an important role in tapping the tremendous reserves of the Alaskan Arctic.

Technological advance is also opening many new horizons in older fields once thought to be nearly-depleted. Before World War II, production was limited to primary recovery—pumping out the oil until the flow became so small as to be economic. This procedure left five or six times more oil in the ground than was recovered, with only 15 to 20 per cent of the oil in place actually produced.

The development of waterflood and other secondary stimulants changed this picture sharply. By upping recovery to 30 to 35 percent of the oil in place, the new techniques have esssentially doubled the Nation's recoverable reserves.

I repeat, technology has doubled recoverable reserves. It has increased the estimated ultimate recovery of crude oil from proved reservoirs by almost 60 billion barrels—20 times current annual production.

In the future, the industry should continue to increase cumulative recoverability through broader application of existing techniques and the development of new techniques.

In brief, invention and innovation encouraged in part by tax incentives have substantially augmented our recoverable reserves and in doing so have contributed importantly to the goal of strengthening the domestic supply position of the United States.

Other economic benefits attributable to tax incentives

Finally, existing petroleum tax policies have contributed significantly to improving the international payments balance of the United States and to world economic progress which has in turn been beneficial to this country.

In regard to international payments, the key plus factor has been the substantial inflow of earnings from past investments abroad.

These same investments have also played a major role in the economic progress of developing nations. Revenues generated by petroleum development projects have provided these nations with the foreign exchanges so essential to economic development, and have contrbuted to secondary benefits such as the creation of modern transportation and communication systems.

Tax incentives have likewise made a contribution to the conservation of natural resources by encouraging the use of marginal oil rather than abandoning this oil. To leave oil of marginal value in the ground is an inexcusable waste of an exhaustible, non-replaceable natural resource. If a marginal well is shut down, the likelihood of its again producing is remote. If it is reopened, it will only be at a considerably higher price for its output. If the production is lost, the country is the poorer.

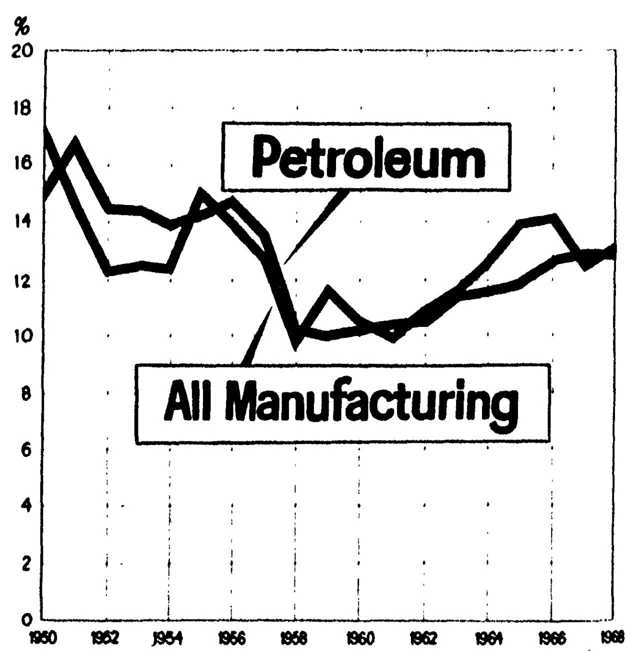
Incentives provided are not excessive

All of these benefits—adequate oil supplies, favorable oil prices, technological progress—have been achieved with the aid of incentives which are not excessive.

If the percentage depletion rate were excessive, for example, this should be reflected in petroleum industry profit performance considerably better than that of other industries. This is not the case. Rather, figures compiled by the First National City Bank of New York demonstrate that the petroleum industry earns only average profits. In 1968, 99 petroleum producing and refining companies earned a 12.9 per cent return on net assets compared with an average return of 13.1 per cent for all manufacturing companies. In fact, the rate of return on net assets for the petroleum industry was higher than the average for all manufacturing companies in only two of the last 10 years. (See Exhibit V).

Exhibit V

Return on net assets Petroleum Industry and all manufacturing after Taxes

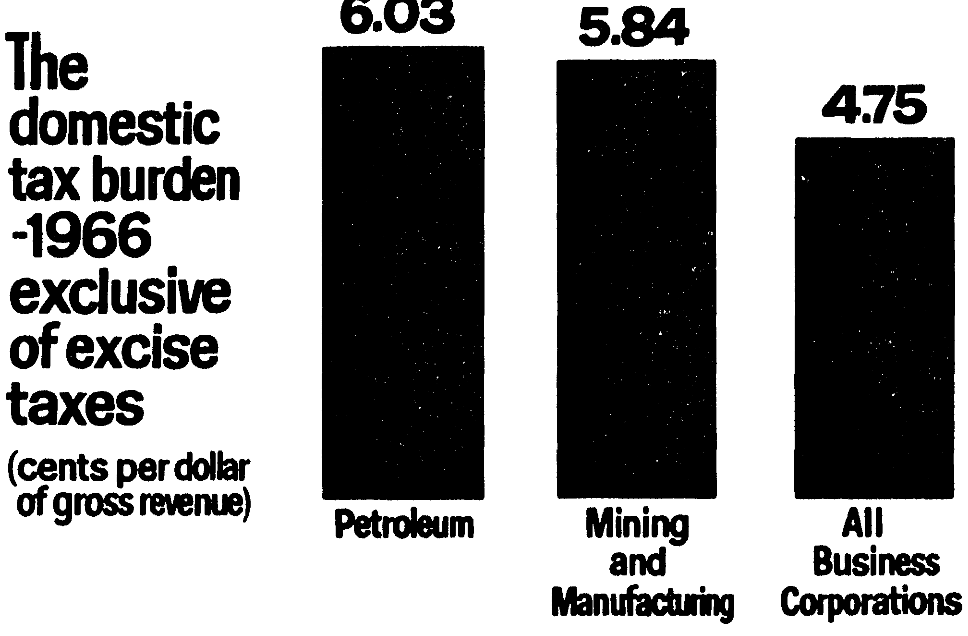


SOURCE First National City Bank

The May 15, 1969 issue of *Fortune* magazine published 1968 financial data of the 500 largest industrial companies in the United States. These data show that, of the 25 largest companies (determined on the basis of sales), seven were oil companies. From a profitability standpoint, however, the record is quite different. Only one of those seven oil companies that rank in the top 25 on the basis of sales was even in the top 100 when ranked on the basis of return on invested capital – and that company ranked only 99th. The companies in the *Fortune* study included 27 oil companies, whose weighted average rate of return on invested capital was 12.0 per cent compared to 12.3 per cent for the other companies.

Similarly, the petroleum industry carries an overall direct tax burden exceeding that borne by other industries, even though its federal income tax bill is reduced by the depletion provision. Lower income taxes are offset by the heavier burden of other direct taxes such as severance and property taxes. As a result, studies have shown that total taxes paid by the petroleum industry, exclusive of motor fuel and excise taxes, in 1966 were equivalent to 6.0 per cent of revenues. (See Exhibit VI). Mining and manufacturing corporations paid direct taxes equivalent to 5.8 per cent of revenues in that year, and all business corporations paid taxes equal to 4.8 per cent of revenues.

Exhibit VI



Current problems and future prospects

Against that background of past experience, I would like now to direct your attention to the petroleum industry's present situation and to its future prospects.

Very frankly, the industry today is eyeball to eyeball with some very serious problems. Steady and substantial increases in petroleum demand have collided head-on with sharply-rising oil finding and development costs, with the result that reserves relative to requirements have been declining. Last year the decline was not only relative, but absolute. Proved petroleum reserves dropped across-the-board during 1968, with the life index of crude oil reserves falling to under 10 years and that of natural gas reserves decreasing to less than 15 years. This does not include the new Alaska reserves which are still being evaluated.

The industry's capability to respond successfully to this challenge could well be determined by the decisions made by this Committee. For this reason I will take a few moments to delineate our major difficulties.

First, the domestic industry is caught squarely between sharply rising costs and moderately rising prices. As I noted earlier, the price of crude oil has risen considerably less than the wholesale price index over the past decade. On the other hand, inflation has boosted exploration costs sharply, and, more significantly, unit costs have been rising because fewer giant fields are being discovered. This upward trend in unit costs is likely to continue since the major new successes are occurring in offshore areas and in Alaska where per well costs are several times higher than onshore ventures in the "lower 48." Parenthetically, it should be recognized that in the long run the cost of crude from Alaska's North Slope will likely average substantially above the unit cost of the enormous field initially discovered.

While improvements in exploration technology have helped to offset rising unit costs a gap continues to exist, particularly in onshore areas where economic exploration ventures are becoming increasingly scarce. A similar problem exists in regard to recovery technology. The most attractive opportunities have already been developed, and further expansion will be dependent upon improved economics based on new technology and the continuance of effective tax incentives.

The natural gas problem differs somewhat from that of crude oil in that the federal government has provided incentives with one hand and taken them away with the other. In other words, the positive effect of tax incentives has been offset by Federal Power Commission regulation of well-head natural gas prices. Under regulation, natural gas sold in interstate commerce is priced below its free market value. In carrying out its gas regulatory responsibilities, the Commission has unfortunately focused its efforts on costs at the expense of supply. It has attempted to apply regulatory techniques developed for public utilities to an intensely competitive industry where survival depends on not investing in low or negative return areas. As a result, only the most favorable natural gas prospects warrant investment in an exploratory venture today.

The serious nature of the present situation was pointed up recently by Federal Power Commissioner Albert B. Brooke, Jr., who declared that the gas industry today faces a "crisis situation." He said that the most obvious, urgent and pressing problem is that of gas supply, and that the next five years "may well prove to be the crucial years." Estimating that demand would grow at a 5 to 7 per cent annual rate, he added that it was unquestionably certain that eliminating or modifying any of the provisions of the tax incentive package would lead to higher consumer prices or more restricted supplies.

In spite of the gas industry experience, it appears that some observers would like to see the crude producing sector of the petroleum business follow the same course as that mandated for gas—to produce at minimum short-run costs regardless of the effect on supply and long-run costs to consumers. If we had followed this advice in the past, the giant fields where our reserve productive capacity is concentrated would be largely depleted, and encouraging new discoveries offshore and in Alaska would probably not have been made. As a result, we would have no reserve capacity today and we would be unduly dependent on foreign oil. In contrast, I believe that proposals for modification of the incentive structure should be directed toward increasing the efficiency of resource development in the long run.

Problems exist also for United States oil companies operating abroad. First, economic factors have led to a deterioration in return on investment. Second, host governments, to further improve their positions, are establishing national oil companies and demanding participatory shares in the development and sale of their crude oil. At the same time, crude deficient countries are establishing their own oil companies to discover and develop new supplies. As a result, United States firms find the going increasingly difficult. They must compete with nationally supported companies to obtain the right to explore and develop new areas, and then, having done so, must compete with national producing companies in selling their crude in foreign markets.

In the financial area, sharply increased capital requirements pose additional problems for the industry. I will mention just two points for your consideration. First, there has been a substantial increase in the debt to equity ratio of the larger oil companies. Since this trend cannot, of course, continue indefinitely, any further reduction in internally generated funds must necessarily lead to reduced expenditures on petroleum exploration. And, second, present tax proposals that would reduce the availability of funds to independent operators will immediately and directly reduce their exploratory activities.

As I noted earlier, the petroleum industry is not excessively profitable. To the extent that tax change proposals are geared to the assumpton that it is, they are off base, indeed.

In brief, our present petroleum situation suggests that the industry today requires increased rather than reduced incentives.

THE IMPACT OF HIGHER TAXES ON PETROLEUM

Now, in the light of the current petroleum situation and the problems faced, what would be the impact of higher taxes on the industry?

Increased taxes, in the absence of any remedial action, must affect either profits and investment or prices. The alternative effects would be (1) reduced earnings and consequent reduction in capital invested in petroleum exploration and development; (2) increased product prices; or (3) some combination of the two.

Since the petroleum industry at present earns only average profits, a decline in profitability due to higher taxes would impair its earnings position relative to that of other industries. Since added tax costs cannot reasonably be expected to be absorbed, a tax increase would mean a reduction in the rate of investment by the industry. However, decreased investment in the face of a declining reserve trend and a steady increase in petroleum requirements is an unacceptable alternative if we are to continue our present policy of maintaining a strong domestic industry capable of meeting essential petroleum requirements.

The second alternative would be to shift the increased tax costs to consumers through product price increases. Because of the relative price of competitive fuels for other uses, price increases would probably be limited to fuels supplying transportation energy, such as jet fuel, diesel fuel and gasoline.

To the extent these products are used in business endeavors, the added cost would simply shift the deduction from one industry to another with no net gain to the Federal revenues, or shift the impact further along the line through succeeding price increases. The Federal Government, as the largest single consumer of petroleum products, would bear a significant portion of any price increase. Only to the extent such additional costs were borne by individuals in non-business pursuits can it be assumed that, in the short run, the federal revenues would benefit.

An examination of this phenomenon discloses the effect to be regressive. A recent study indicates expenditures for gasoline per dollar of income are greater for the low income group than for middle and high income groups. The lowest income group, with earnings of less than $3,000 annually, spends an average of 6.2 cents of every dollar of income on gasoline, compared to only 1.5 cents per dollar in the group earning $15,000 or more. Because much of the driving of the low income group is work-oriented, their demand is relatively fixed, according to this study. Hence, the impact of an increase in gasoline prices would be four times greater on the lowest income group than on the highest income group.

Thus, a price increase to offset a tax increase would bear most heavily on the federal government and on low income households. It is by no means clear to me that this would be a net social gain.

Before leaving this topic, I would like to present some background information indicating the effect on the industry of complete elimination of tax incentives. In my view, these data point up very sharply the importance of present petroleum tax provisions to our national security.

Elimination of all petroleum tax incentives would have approximately the same impact on the domestic industry as the elimination of import controls, which would reduce revenues per barrel by about one-third. In the view of most industry respondents to the questionnaire issued by the Cabinet Task Force on Oil Import Control, the key effect of a one-third drop in revenue per barrel would be the "virtual cessation" of exploratory drilling. According to one company, elimination of the import control program or an equivalent decrease in revenue would result in an 85 per cent drop in the volume of exploratory drilling. According to another, the resulting reduction in industry cash flow would mean a "sharply curtailed" exploration program with a resultant permanent loss of "supporting industries, technology and trained people."

What this reduction in exploratory drilling might mean for future reserves was examined by another respondent. According to this estimate, "the amount of oil not discovered—which otherwise would be discovered—might approximate 1 to 2 billion barrels *each year* in the established older exploration provinces." This would amount to some 10 to 20 billion barrels lost over the next decade, *not* including the unknown amount which "otherwise would be discovered" in newer or future geologic provinces. The same respondent estimated the loss in reserves in existing developed fields at 6 to 10 billion barrels. The loss in reserves in fields which have been discovered but not developed was estimated at 5 billion barrels.

Six companies estimated that by 1980 the United States would be dependent on foreign sources for one-half to two-thirds of its petroleum supplies if oil import controls were eliminated. (See Exhibit VII). The average of these forecasts was 57 per cent dependency on foreign oil. And this allows for remaining production from reserves already discovered today, including the prolific discovery on the

North Slope of Alaska, which has not yet been produced. The estimates made by these companies are in close agreement with projections made by the United States Department of the Interior, which predicted 48 per cent (optimistic) to 58 per cent (pessimistic) dependency on foreign oil by 1980 if oil import controls were eliminated.

EXHIBIT VII

1980 percentage dependency on foreign oil in the absence of oil import controls during the 1970's

Respondent:	Percent
Cities Service	68
Gulf	54
Humble	49
Marathon	61
Phillips	57
Sohio	54
Average	57
Department of the Interior	48 58

Source: Computed from data in submissions in July 1969 to the Cabinet Task Force on Oil Import Control.

Earlier, I indicated that the only alternative to maintaining a strong domestic industry was increased reliance on foreign oil. The above data clearly indicate how heavy that reliance would be if all petroleum tax incentives were eliminated.

In respect to the security aspect of these foreign supplies, I would like to quote from the summary of a recent API statement on this subject:

"Interference with foreign petroleum supplies can come from any of three sources: (1) military action during war; (2) shutdown (or sabotage) for political reasons or (3) shutdown for economic reasons. The first of these is most important in general wars. Even in the absence of general war, however, there can be serious petroleum security problems in all three categories. Since World War II, there have been *eight* noteworthy interruptions of overseas petroleum supply—all in the prolific Middle East and African producing areas.

"None of these interruptions has succeeded in obtaining economic or political concessions from the United States or its allies—primarily because there has been a large, viable North American oil industry on which to rely in the event of emergency.

"If the United States were to adopt public policies which would make further exploration in North America generally unattractive, the United States would then have to turn to the Middle East-North Africa region for the bulk of its petroleum supplies because 86 per cent of overseas reserves are concentrated in this area (Venezuela currently accounts for 17 per cent of production but has only 4 per cent of reserves—See Exhibit VIII.) While no single overseas producing country has a sufficiently large share of reserves to be able to dominate the international oil market, *groups* of countries having common interests do have large shares.

EXHIBIT VIII

Share of 1968 free world crude oil reserves outside North America

Areas:	Percent
Persian Gulf countries	75
North African countries	11
Subtotal	86
Venezuela	4
Indonesia	3
All other	7
Total	100
Groups:	
OPEC [1]	85
Arab nations	71

[1] Organization of Petroleum Exporting Countries.

"Certain groups have, in fact, demonstrated an intent to operate as economic units for certain objectives. In the absence of a viable North American industry to counter the potential market power of these groups, there is every reason to anticipate that they would act as monopolistic entities for economic and political gains at the expense of consuming countries. The potential danger of this situation to the security of Free World energy supplies is compounded by increasing Russian adventures in the Middle East and North Africa, the principal overseas producing areas."

While we would gain a short-run benefit from foreign oil in temporarily lower prices, we would bear a long-run cost that cannot be measured in monetary terms. If we became dependent upon that oil, we might well be drawn into any conflict that occurred in the Middle East in order to insure stability. This position would be analogous to our present role in Southeast Asia, except that here the the military and economic reasons for intervention would be compelling.

Furthermore, given the Soviet Union's support of the Arab world, any increased United States role in the Middle East could lead to a direct confrontation between the two nuclear superpowers. In any event, our options in international affairs would be severely limited and our military commitments would be increased at a time when we seek to limit them.

In summary, I would like to leave these five salient points with you.

(1) Present petroleum tax incentives have served the national interest by providing *adequate, secure* supplies of oil and gas, efficiently produced.

(2) Petroleum industry profits have been *less* than average.

(3) Petroleum industry total taxes have been *more* than average.

(4) Petroleum industry prices have risen *less* than average.

(5) Petroleum industry supply problems over the next decade will be enormous, since we *must produce 40 per cent more oil than in the 1960's.*

Before closing, I should like to dispel two contradictory notions which are prevalent today. The first is that the United States is running out of oil. The second is that we have found enough oil in Alaska to meet our needs forever. Neither of these notions is true. In my view, recent experience indicates that it is reasonable to expect a substantial uptrend in new oil found in the United States during the next decade. Crude oil reserves in Alaska could very well be as large as the present total in the continental United States 31 billion barrels. However, that would only be 55 per cent of estimated required additions to reserves during the 1970's (and all of the Alaskan oil will probably not be found and developed during that period). We need, therefore, more discoveries in the "lower 48" states. I am convinced that a realistic national petroleum policy continuing to provide reasonable tax incentives for investment will enable us to find and develop the oil we need, to the benefit of this Nation and all of its people.

In conclusion, I urge the Committee to give careful consideration to the future outlook for the United States petroleum situation in reaching its decision about petroleum tax policy. The continued existence of the United States as we know it could well rest on the decisions you reach.

STATEMENT OF WILLIAM I. SPENCER, EXECUTIVE VICE PRESIDENT, FIRST NATIONAL CITY BANK, NEW YORK, N.Y., IN BEHALF OF AMERICAN PETROLEUM INSTITUTE; MID-CONTINENT OIL & GAS ASSOCIATION; ROCKY MOUNTAIN OIL & GAS ASSOCIATION; AND WESTERN OIL & GAS ASSOCIATION

SUMMARY

1. Changes in the tax treatment of minerals, as existing for many years, could endanger both the international payments position and the energy supplies of the United States. They could thus have serious, long-term consequences for the welfare of the nation as a whole.

2. The petroleum industry has been responsible for the largest share of United States direct investments abroad, and for those showing the highest return on book value. Helped by a flow of almost \$2 billion (1967) in earnings remitted back to parent companies, the industry has made a major and sustained contribution to the strength of the dollar. Most of the funds required to make this possible come from sources outside the United States.

3. The national need for energy will grow by more than 50% by 1980. Two-thirds of the supply will come from oil and gas, supplemented by other capital-intensive sources such as shale oil. If this petroleum supply is to be made available, and if there is to be no increase in dependence on imports, the annual rate

of additions to proved reserves in the ground will have to be 57% higher in the 1970's than in the 1960's.

4. Making conservative assumptions concerning the cost of raising the rate of discoveries to this extent, the petroleum industry will have to attract, for domestic exploration and development alone, as much as $70 billion for the 10-year period through 1980.

5. In attracting capital on this scale, the industry will be hampered by the likely continuance of monetary stringency in the economy as a whole; also, by the fact that the liquidity of leading petroleum companies has been declining, while their dependance on long-term debt has been rising sharply.

6. The ability of the industry to finance its greatly-increased exploration and development will depend upon its future ability to maintain and improve its profitability. When related to investments, its profits are at best average and significantly below those of other industries facing a lesser degree of risk.

7. The tax structure should be designed to enable the industry to meet our national energy goals. The proposals before the Committee do not meet this test. They are not simple; they are not stable; and they are not in tune with long-term needs.

STATEMENT

I am William I. Spencer, Executive Vice President of First National City Bank, New York. My appearance today is on behalf of the American Petroleum Institute, the Mid-Continent Oil & Gas Association, the Rocky Mountain Oil and Gas Association and the Western Oil and Gas Association. For many years I was directly associated with the petroleum and mineral activities of our Bank. I therefore feel honored to appear at these important hearings, and to discuss with you a few of the basic problems presented by some of the proposals now being examined by this Committee.

Since the importance of energy to the national economy has already been so clearly set out by Mr. Dunlop, I shall confine my remarks to two broad areas. In the first place, I shall briefly discuss the importance of petroleum in strengthening the United States position in international trade and payments. Secondly, I shall urge you to consider most carefully the industry's capital needs.

On the first point, let me make it clear that I have no doubt of the advantages to the United States of a growing flow of international trade and payments. I have just returned from a visit to Africa where I was struck by the extent to which American people, American capital and American ideas are not only working to increase our income but also to strengthen our image in the most remote places. To forget the interdependence of the United States and its trading partners abroad would be a little like trying to run Manhattan without the tunnels and bridges connecting the island to the mainland.

Yet the balance of payments problem will remain with us for years to come. International liquidity and the strength of the dollar are likely to be matters of great concern for policy-makers here in Washington throughout the 1970's. In this international context, the importance of petroleum is well known. It occupies first place in seaborne trade and foreign earnings. No change in the tax treatment of this and other mineral industries should be attempted before carefully weighing the impact on international payments.

Our Bank has often expressed concern over the policy of restricting capital outflows by the system of controls introduced early in 1965. Similar objections would apply to tax changes likely to interfere with earnings from direct investments abroad. Over the years, petroleum investments abroad have shown their ability to earn a return on book value appreciably better than that of other investments aboard.

The net effect of the foreign investment activity of the petroleum industry has been an inflow of funds of nearly $1 billion annually. Not only has this been most important in supporting the national balance of payments; but it has also greatly strengthened the economies of developing countries. In key countries in Asia and Africa, as well as in international shipping, more than half of United States direct investment abroad has been channeled into oil and gas ventures.

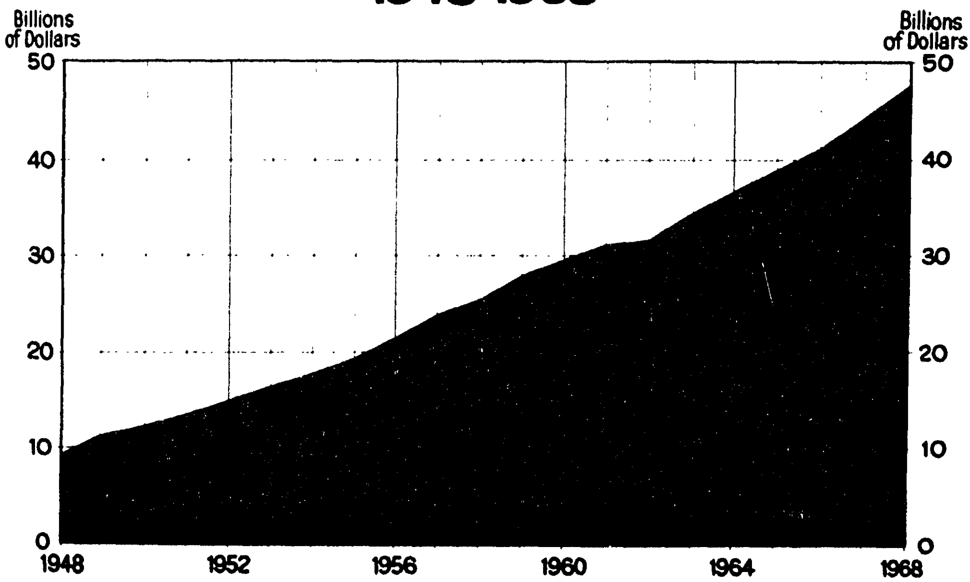
Needless to say, an exact accounting for these benefits is difficult to make. On the minus side is the outflow of capital and the cost of tanker and other foreign services. But the capital invested abroad gives rise to far larger plus items. There are exports of services such as fees and royalties, and exports of merchandise such as products, equipment and petrochemicals. There is also the sizable return flow of earnings remitted back to parent companies. In 1967 (the latest available year), this amounted to almost $2 billion. Without these earnings, the United States balance of payments deficit would have been half as large again as that actually recorded. This seems a good reward for the outflow of $1.1 billion that took place in 1967 in order to support investments abroad. Indeed, most of the capital now required for this purpose is not drawn from sources in the United States, but from earnings made and reinvested abroad and from sums raised from investors abroad.

Now, gentlemen, I should like to turn to the capital outlook. Specifically on petroleum, I should like you to look at Exhibit I. We have prepared it to show the trend of capital investment in the petroleum industry over the past 20 years. You will note that the net assets of United States petroleum companies have grown from $9.2 billion in 1948 to $47.5 billion in 1968. The reason investors have been willing to risk their money in this business is, of course, that they were anticipating an adequate return on their money. Tax incentives played an important role in attracting investors to this industry. At the same time, the industry's profits have not been excessive, as Mr. Dunlop has demonstrated.

Exhibit I

CAPITAL INVESTED IN THE PETROLEUM INDUSTRY

1948-1968



There seems to be an impression, expressed during the hearings early in September, that these tax incentives are expendable. I support the case for sharing the tax burden as equitably as possible. As the President himself has pointed out, taxes can be made fair—but not popular. Reducing the mineral tax incentives, as now under discussion by this Committee, might be popular today. But will it be popular 10 years from now? In the long run, because of the danger of an energy shortage, I do not think it would be wise or fair. In fact, during the 1970's, tax incentives for mineral production will be even more essential than during the 1960's.

I am not saying that the tax system should be left unchanged. But any tax system should meet the tests of being simple, stable and in tune with long-term economic needs. Insofar as the mineral provisions are concerned, I do not find that the proposed measures meet any of these tests. The proposals now before the Committee appear to make the system even more complex. They appear to undermine the stability so vital to productive invesment. And they conflict with long-term needs by adding a bias in favor of consumption and unfavorable to investment at a time when the nation is struggling to rein in an inflation that threatens to run away.

My concern extends across the whole range of minerals. Coal, uranium, copper, and other basic resources will be essential to our economy in the future even more than they have been in the past. Oil shale will one day come into its own as a major source of the nation's energy. But, in the rest of what I say, I shall be focusing on oil and gas. These provide the foundation for the largest industry in the mineral group. Moreover, the added petroleum tax load proposed in the mineral provisions of HR 13270—over $500 million out of a total of about $600 million for all minerals—is far larger than for any of the other minerals.

Looking at the petroleum industry from a banker's viewpoint, I see no reason for overconfidence that this country can successfully cope with the petroleum demands of the 1970's. I see no justification for a crack-down on the petroleum industry. Instead, I think the industry will need all the cooperation it can get from this nation. Let me tell you why.

As a banker, I am uneasy about the petroleum industry's capital outlook—how much capital it will require and how much it can obtain. I see all too little basis for the confidence that was expressed by Administration spokesmen before this Committee concerning the adequacy of the capital supply.

In the first place, there is the shortage of capital in the economy as a whole. With the big corporations—and even the Federal Government—having to pay 8% or more on recent bond and note issues, the present stringency is clear for all to see. Nor do we expect any early relief. In a recent 5-year forecast, we came up with the prospect of a sharp increase in the need for both short and long-term borrowing by leading United States industries. For petroleum, we expect to see a drastic increase in the use of outside funds, with the total of short-term borrowing being doubled by 1974.

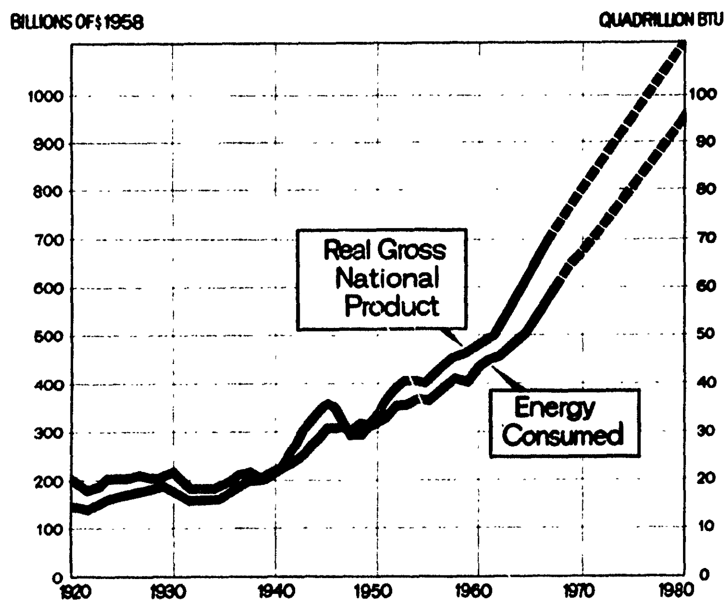
This trend has already set in. Over the past 10 years, the call for outside financing has obliged the five largest international oil companies based in the United States to step up the long-term debt component in their total capitalization. Their long-term debt has risen sharply—from about $2 billion in 1958 (9% of the total) to $6 billion (17%) last year. There comes a point beyond which even the strongest company cannot continue to depend on borrowing to finance its expansion plans.

In the second place, the needs of the energy sector as a whole are bound to mount rapidly. By 1980, we expect the United States to be consuming nearly 95 quadrillion British thermal units of energy (see Exhibit II). This would represent an increase of more than 50% over the present total of 62 quadrillion.

The expected demand for energy in 1980 represents some 45 million barrels a day of crude oil equivalent (see Exhibit III). Some 42% of it will actually come from oil—including a small contribution from synthetic fuels, such as shale oil. Over 25% will come from gas. But this leaves some 33% to come from other sources. One of these will continue to be coal, which will contribute nearly 18%. Other sources may include 12% from nuclear power and 3% from water power. The new energy sources are likely to prove quite as capital-intensive as petroleum. To an unparalleled extent, oil companies will be competing with other companies for the capital needed to secure the nation's energy supply.

Exhibit I

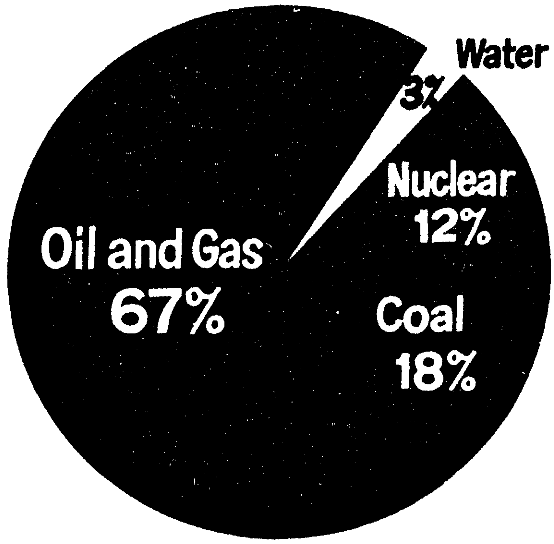
U.S. energy use and gross national product are closely related



SOURCES: [illegible]: GNP-Dept of Commerce, Office of Business Economics
Energy: Bureau of Mines
SOURCE: [illegible]: First National City Bank

Exhibit III

Distribution of Total Energy Consumption in 1980



Let us next look to the future, and try to apply a yardstick to the capital requirements of the industry in the years ahead. At the outset and very broadly, let me say that, over the 10-year period 1970 to 1980, the petroleum industry may require at least $70 billion for domestic exploration and development expenditures alone. This average expenditure of $7 billion a year would be more than half as high again as the average for the last 10 years.

Even this figure may prove to be a low estimate rather than a high one. It does not include at least $5 billion for transportation investment. Further, it makes no allowance for the possible impact of inflation or for the cost increases due to exploration at greater depths and in less accessible areas. Here is how we arrive at our projection.

We estimate the energy consumption in the United States will grow at nearly 4% a year during the 10-year period 1970 to 1980. We believe that, through 1980—and for a good many years thereafter—petroleum liquids will continue to furnish the energy for almost all our transportation. This market, together with petrochemical feedstocks, will provide a strong springboard for the growth of total consumer requirements for petroleum products.

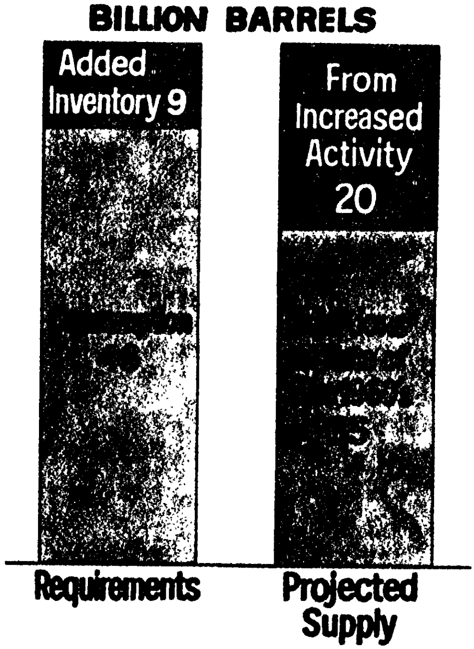
In 1980, according to our estimate, United States consumption of petroleum liquids will reach 19 million barrels daily, nearly 6 million barrels daily more than we consumed last year. (This forecast, incidentally, falls within the same general range as a number of estimates prepared by other groups.) Assuming that imports continue to provide 22% of domestic demand (as in 1968), this would mean that the domestic industry will be called upon to supply some 41% more petroleum liquids in 1980 than in 1968—if the country is to attempt to avoid becoming relatively more dependent on imports.

Shown in Exhibit IV is an indication of the scale of the exploration effort that will be required to meet a growth in demand of this magnitude. The industry would have to produce 46 billion barrels of liquid hydrocarbons during the 1970's. By comparison, total production during the 1960's was only 33 billion barrels.

33-865 O—69—pt. 5——36

Exhibit IV

55 billion barrels required gross additions to liquid hydrocarbon reserves during the 1970's



In addition to this need for 46 billion barrels, if the industry is to meet the full requirement in 1980, another 9 million barrels will probably have to be added to the inventory of proved reserves. The reason for this is the technological limit on the percentage of reserves that can be produced from any reservoir during a given year.

Thus, gross additions to reserves required during the 1970's total 55 billion barrels: 46 billion for consumption and 9 billion for inventory. This total—an average of 5.5 billion barrels per year—is 57% more than the annual average of 3.5 billion barrels that the industry added during the 1960's. Continuation of additions at the 1960's rate during the 1970's would leave the country 20 billion barrels short by 1980.

These figures are based on the assumption that the nation will continue its reliance on petroleum imports at today's 22% level. Our own estimate is that this dependence will increase to around 24% by 1980. This would decrease, but not by a sizeable amount, the need for additions to domestic reserves.

Nor must we forget the demands of the gas consumer. Our estimates suggest that potential demand for this fuel is now entering a new period of growth. For reasons of convenience, domestic and commercial users are turning increasingly to gas. Nearly half of the industrial energy needs of the United States are already supplied by gas. More than one-fifth of the nation's electric power supply also depends on this fuel.

Yet, is it clear to us that the future availability of gas is becoming a matter of grave concern. By 1980, we expect demand to have grown to 66 billion cubic feet a day—more than 20% above the present level. This comparatively modest growth takes account of the fact that gross additions to gas reserves are no longer growing as fast as the market potential. More funds will have to be earmarked for gas exploration if the consumer is not to be forced to resort to higher-cost synthetic sources, or to substantial dependence on gas imports. These imports would have to come both by pipeline from Canada and by tanker, in most costly liquefied form, from overseas.

Returning to petroleum liquids, what is likely to be the cost of obtaining the required 5.5 billion barrels a year? During the last 10 years, the industry spent an estimated $4.5 billion annually to obtain the annual increments of 3.5 billion barrels, mentioned above. If average gross additions to reserves must increase 57%, recent levels of capital expenditures cannot be expected to meet the needs of the future.

Yet there is no neat relationship between capital expenditures and gross additions to reserves. The additions include not only new discoveries, but extensions and revisions. They also include the result of improvements in recovery processes, and the liquids to be derived from gas wells. At the same time, gas-oil ratios will vary, thus altering the capital requirement. There is no guarantee whatever that changes on these various fronts will allow the industry to hold its overall rate of expenditures per barrel at the average achieved in recent years.

There is the further complication that the industry is having to pioneer into more and more difficult areas in order to meet the nation's needs. Wells are getting deeper. More of them have to be located offshore. Average costs per well in Alaska are likely to be at least five times those in the Lower Forty-eight. Other oil frontiers are also having to be opened up.

Some figures drawn from recent history will help to illustrate my point. For example, the cost of drilling and equipping an average producing well in 1953 was $54,000. It had increased to $81,000 by 1967, and as high as $913,000 for a productive well over 15,000 feet deep. Compare the 1967 average, however, with 1967 costs of $550,000 for a typical productive offshore well, and $1,250,000 for a productive well in Alaska. The higher of these figures are more representative of drilling costs in the areas and at the depths that will require a major exploratory effort, if we are to meet our future requirements for oil and gas reserves.

As I have already mentioned, there is also the onward march of inflation. I am not one of those who believes that a price increase automatically generates additional earnings and attracts the necessary supply of capital. As has been demonstrated by Mr Dunlop, the industry has been in a cost-price squeeze. Wellhead and refined product prices have clearly failed to keep up with the rise in the price level as a whole.

Merely for the sake of illustration, however, we have assumed that capital expenditures will increase by the same percentage as the necessary additions to petroleum liquid reserves. Using the 57% estimated increase, the average annual expenditures will grow from $4.5 billion to $7 billion. That is how we arrived at our total of $70 billion for the decade 1970 to 1980.

Let us now consider the prospect of attracting this stepped-up capital inflow into the petroleum industry.

As I have already indicated, I see no evidence whatever that there is a surplus of available capital in the country today. Nor is there the prospect of one in the years ahead. Is there a surplus of capital in the petroleum industry itself? The answer is clearly negative. As I have just demonstrated, there are certainly not enough proved reserves in the ground to get the industry through the 1970's. Similarly, there is no excess cash within the industry

For a representative group of companies that we analyzed, the ratio of current assets to current liabilities at the end of last year was only 1.8 to 1. This is less than the 2 to 1 ratio that is often taken as the desirable minimum. The petroleum ratio compares with an average of 2.2 to 1 for other manufacturing industries, and with even higher rates for steel, chemicals and so on. At a time when these other industries have been maintaining their liquidity at reasonable levels, it is ironic that petroleum, one of the most vital of all, has not fared so well.

Are the industry's profits high enough to attract the huge sums of capital likely to be needed? Although large in absolute terms, when related to investments, the profits are at best average. Industries which do not have to face the risks and uncertainties borne by petroleum have in recent years been earning up to some 20% in relation to their assets against oil's ratio of less than 13%. Among the more fortunate group in 1968 were office equipment, instruments, pharmaceuticals, toiletries and soft drinks. Hardware and tools earned more than 16%, as did the automobile industry. The petroleum industry is only likely to attract the stepped-up capital needs of the 1970's if its profit performance is maintained and improved.

What is the petroleum industry's profit outlook for the future? An adequate answer to this question requires, as one most important condition, a clearer view than we now possess of the tax prospect. I shall not try to go into the detail of the tax bill prepared in the House of Representatives. But I must frankly confess that I am struck by the negative emphasis in some of the proposals now being considered by this Committee.

You, yourself, Mr. Chairman have referred to recent proposals as "anti-oil". I note, in this connection, that there are the proposed changes in the depletion allowance, reducing the rate for domestic production and eliminating it for foreign production. There is the new concept of the limit on tax preferences, restricting the use of percentage depletion and intangible drilling-cost expensing. There are the further complexities in the application of foreign tax credits; the proposed restrictions could introduce a new element of double taxation, thereby breaching one of the most fundamental principles of fairness in taxation.

Petroleum industry profits emerge as a main target of this array of tax proposals. If the Congress adopts part or all of this package, an investor must expect to earn less from his petroleum outlays.

Some people argue that the impact will be slight. In the report of the Committee on Ways and Means, I read the surmise that the proposed reduction in percentage depletion rates "should have only a minimal effect on efforts to discover new reserves".

Judging by the Treasury's figures, I find this statement hard to support. Moreover, there is the psychological impact. Once the gate to change has been opened, investors become increasingly nervous. These tax changes are not only retroactive; they cast shadows before them. Any undermining of the existing tax structure will inevitably have a more than proportionate effect on investor expectations, and therefore on capital availability.

At the same time, lower profits mean a smaller flow of internal funds available for reinvestment in the industry. In the past, over 70% of the capital spending of the leading oil companies has been provided from internal sources. In the future, under an impaired system of tax incentives, these internal funds could be deeply eroded.

I think it is unfortunate that there is so much eagerness to place obstacles in the industry's path at a time when its capital needs are so great, and when the country's petroleum requirements are on such a steady rise. I am, indeed, puzzled by the timing, and by the sense of haste during some of the hearings on the complex and varied tax proposals now being considered by this Committee. I think there is a danger that perspective will be lost. With the Treasury expecting to raise almost $200 billion in revenues during the current fiscal year, budgetary savings and tax simplifications are more desirable than ever before—but only if they do not backfire on the economy. Tax savings that might risk the future energy supplies of the nation could do just that.

I fully agree with those around the nation who feel the need to "do something" about our mammoth and ever-mounting budget. Yet let us not underestimate the gravity of the problem, nor the need for cautious study before far-reaching actions are taken.

To sum up, a reduction in established tax incentives could reduce petroleum industry profitability to something well below that of other industries, thereby endangering the future capital supply. This could have serious—and insufficiently understood—long-term consequences for our balance of payments, our economic stability, and the welfare of the nation as a whole.

STATEMENT OF GEORGE V. MYERS, EXECUTIVE VICE PRESIDENT, STANDARD OIL CO. OF INDIANA, CHICAGO, ILL., IN BEHALF OF THE AMERICAN PETROLEUM INSTITUTE; MID-CONTINENTAL OIL & GAS ASSOCIATION; ROCKY MOUNTAIN OIL AND GAS ASSOCIATION; AND WESTERN OIL AND GAS ASSOCIATION

SUMMARY

1. Risks in Finding:
   a. Significant discoveries, one well out of 50.
   b. Unpredictability of success for individual prospectors.
   c. Past averages may mean little in view of the increased costs of deeper wells and wells offshore and in remote areas.
2. H.R. 13270:
   a. Effect of Reducing Domestic Depletion Rate.
      i. Curtailment in exploration and development leading to an undue reliance on foreign oil.
      ii. Apprehensions of investors that further reductions may follow.
      iii. Investments made on assumption that long-standing depletion deductions would continue.
   b. Treating production payments as loans will reduce value of producing properties and restrict borrowing power for financing exploration.

c. Allocation of deductions discriminate against independent individual operator by reducing the effectiveness of his percentage depletion and intangible drilling costs.
d. Oil Shale.
i. House versión should be adopted.
ii. Retorting is a mining process and is proper cut-off point for depletion.

3. Comments on Treasury Department Proposals:
a. Inclusion of percentage depletion and intangible drilling costs in LTP computation.
i. Percentage depletion not categorized by Treasury Department study of 154 individuals as a "major tax reducing factor". Amounted to less than 1 percent of total deductions claimed by 154 individuals.
ii. Sixty percent rule for intangible drilling costs is arbitrary and discriminatory and will dry up sources of risk capital for independent operators.
b. Taxation as ordinary income of gains from sale of properties to extent of previously allowed intangible drilling costs will lower incentives for investment in exploration.

4. Other Proposals:
a. Plow-back of depletion deductions.
i. Depletion a reward for past success. Plow-back locks in investors.
ii. Encourages the drilling of inferior prospects.
iii. Industry will become concentrated in fewer producers.
iv. Producers who have borrowed against future production will lose part of their depletion unless they can repay their loan and plowback.
b. Capitalization of intangible drilling costs of development wells.
i. Will not ultimately increase tax revenues.
ii. Will seriously disrupt available funds.
c. Percentage depletion at graduated rates.
i. Industry not concentrated.
ii. Effect of proposal is to reduce the industry to a rate a little higher than 15 percent.
iii. Risks same for all.

5. Conclusion:
a. High risks are deterrent in attracting capital under present economic conditions.
b. Proposals to reduce depletion rate, and to eliminate capital incentives in form of production payment sales and ABC transactions will adversely affect the capital raising abilities of the independent operator.
c. The discriminatory proposals of the Treasury with respect to depletion and intangible drilling costs in the LTP and allocation of deductions computations will seriously affect the capital raising potential of independent operators.
d. In view of the high risks involved, the proposals in the House bill and in the Treasury testimony, if enacted, would drive capital out of the search for petroleum.

STATEMENT

My name is George V. Myers. I am Executive Vice President and a Director of the Standard Oil Company (Indiana) of Chicago, Illinois. I am appearing today on behalf of the American Petroleum Institute, the Mid-Continent Oil & Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association. I will discuss, first, the risks inherent in exploring for oil. Then I will review the provisions of H.R. 13270, the proposals made by the Treasury, and a few other proposals that would reduce economic incentives for domestic petroleum exploration and development.

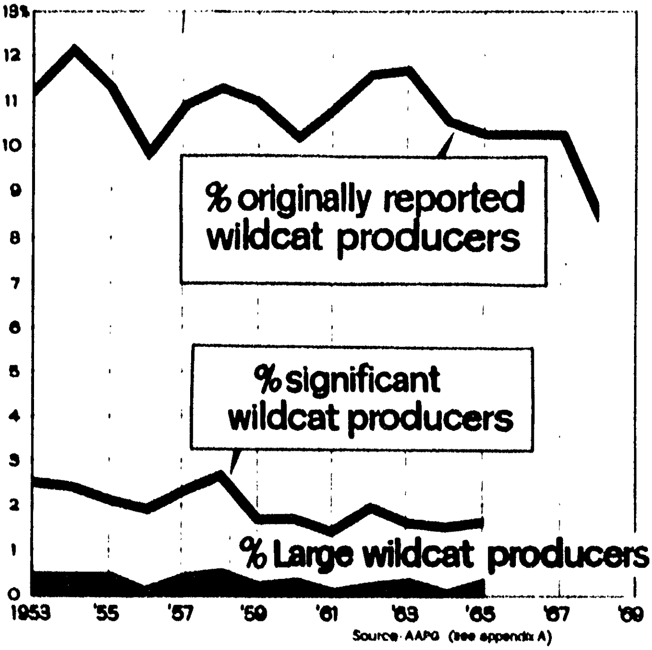
RISKS IN FINDING OIL

Unique and heavy risks are involved in finding and producing oil and gas. These risks are just as real today as they were 10, 20, or 50 years ago. In spite of all of our scientific progress and new exploration tools, there is still only one way to establish the presence of oil and gas in the ground; and that is to drill a hole. Recent experience shows that, on the average, only about one out of 50 exploratory wells will find oil and gas in significant quantities; that is, the equivalent of at least one million barrels of oil.

There is still a common belief that one of every nine wildcats will succeed. It is true that, for many years, about 11 percent of wildcats produced some oil or gas, but that figure can be misleading. (Exhibit I) The top line of Exhibit I shows that about 11 percent of wildcats drilled during the period 1953–1967 were originally reported to be producers. In 1968, this rate dropped to 8.5 percent. However, this line is misleading because many of the wells that find oil or gas do not find profitable quantities.

Exhibit I

Productive fields per wildcat well drilled 1953-68



APPENDIX A.—PRODUCTIVE FIELDS PER WILDCAT DRILLED, 1953-68

Year	Number of wildcats drilled	Number of hits: Originally reported	Number of hits: Significant[1]	Number of hits: Large[2]	Percentage of total wildcats: Originally reported	Percentage of total wildcats: Significant[1]	Percentage of total wildcats: Large[2]
1953[1]	6,925	774	164	36	11.2	2.5	0.5
1954	7,380	902	167	34	12.2	2.4	.5
1955	8,105	919	164	36	11.3	2.1	.5
1956	8,742	868	159	15	9.9	1.9	.2
1957	8,014	872	171	38	10.9	2.3	.5
1958	6,950	786	176	39	11.3	2.7	.6
1959	7,031	772	121	18	11.0	1.7	.3
1960	7,320	745	124	26	10.2	1.7	.4
1961	6,909	745	98	16	10.8	1.4	.2
1962	6,794	787	127	22	11.6	1.9	.3
1963	6,570	769	[3] 102	[3] 23	11.7	[3] 1.6	[3] .4
1964	6,632	701	[3] 101	[3] 16	10.6	[3] 1.5	[3] .2
1965	6,182	638	[3] 99	[3] 23	10.3	[3] 1.6	[3] .4
1966	6,158	635	(4)	(4)	10.3	(4)	(4)
1967	5,271	544	(4)	(4)	10.3	(4)	(4)
1968	5,205	442	(4)	(4)	8.5	(4)	(4)

[1] 1,000,000 barrels reserves or more. Applies to 17 States before 1959. Percentages before 1959 based on 17-State total shown in appendix B.
[2] 10,000,000 barrels reserves or more (included in significant hits). Applies to 17 States before 1959. Percentages before 1959 based on 17-State total shown in appendix B.
[3] Preliminary.
[4] Not available.

Source: Derived from American Association of Petroleum Geologists data, most of which are reported in June 1967 bulletin. Care must be exercised in the use of these figures because those reported in 1965-67 bulletins are not precisely comparable with past years.

The next line on the chart shows the percentage of wildcats which found fields having more than one million barrels of oil (or the equivalent amount of gas). You will note that the highest percentage is almost twice as great as the lowest.

with an average of about 2 percent. Therefore, about one well in 50 is a better measure of the industry's average success rate.

The bottom line on the chart represents discoveries of 10 million barrels or more. The odds here are about one out of 250, or a four-tenths of a percent success ratio.

The search for oil and gas is one of high risk, and the degree of industry success is unpredictable, as shown by extreme year-to-year fluctuations of the industry averages. It follows that the degree of success for any one company is completely unpredictable, since no one company is large enough to have "average" characteristics. In any event, wildcats are drilled on the basis of the geological outlook for individual prospects, not on the basis of industry average.

Furthermore, past averages and ratios may well mean little for the future; witness the decline in the wildcat success rate in 1968. Since costs increase as we drill deeper and explore in the more remote areas, million-barrel fields which were significant at shallower depths in mature areas may well be unprofitable at greater depths or in frontier areas. Increased costs effectively decrease the success rate since the average profitable field must be larger in order to offset higher costs. This certainly indicates that the incentives for finding oil and gas should be at least maintained at present levels. Risk capital will be forthcoming only if potential rewards are sufficiently attractive. Past rewards have not been excessive, as indicated by the average rate of return for the industry, which Mr. Dunlop discussed. Adequate rewards were the primary consideration underlying Congress' adoption and continuation of percentage depletion and related incentive provisions in our income tax law.

H.R. 13270

As passed by the House, H.R. 13270 would cut back on the existing incentives to explore for and develop domestic oil and gas reserves by:

1. Reducing the percentage depletion rate on domestic oil and gas wells from 27½ percent to 20 percent.
2. Effectively eliminating the use of production payments.
3. Reducing deductions allowed for interest, charitable contributions, state and local taxes, and other nonbusiness expenses incurred by individual oil and gas operators.

The Treasury Department estimates that the proposed reduction in the percentage depletion rate on domestic oil and gas production would increase the industry's annual tax burden by some $350 million. The elimination of the use of production payments would impose an additional $200 million burden.

Although there is no Treasury estimate of the monetary effect of the third proposal, it is a change that would have a serious impact on the independent segment of the business.

Prior to discussing these proposals in greater detail, I think it is important to point out that their adoption in conjunction with other proposals in H.R. 13270, such as the extension of the surtax, the repeal of the 7 percent investment tax credit, and the capital gains tax changes would siphon a tremendous amount of cash out of the already strained financial resources of our industry. Mr. Spencer has pointed out that our industry will need more, not less, funds if it is to keep up with the demand for ever-increasing volumes of oil and gas required by our economy. This, to me, points up the need for at least maintaining present tax incentives, particularly in view of the increases in future petroleum requirements as outlined by Mr. Spencer.

Reduction in domestic depletion rate

Turning now to the specific provisions of H.R. 13270, I believe that the proposed reduction in the domestic percentage depletion rate from 27½ percent to 20 percent contravenes our national interest. Last year, the Department of the Interior report, "United States Petroleum Through 1980," recognized the importance of existing tax provisions to the development of sufficient new reserves to serve increasing demands. The following statement from this report summarizes the conclusions reached:

> "Both intangible expensing provisions and percentage depletion have been long-standing and durable features of the tax treatment of the petroleum industry, despite repeated efforts to change, reduce or eliminate them.
>
> "They are an integral part of the petroleum industry's structure of income and expense, and the available evidence suggests that any substantial

change in them would have a direct and significant effect upon the future availability and cost of oil and natural gas."

In the capital-intensive petroleum industry, any impairment of existing tax incentive would inescapably cause a restriction in future exploration and development expenditures. Unless compensating product prices could be realized, our economic progress would be dampened and our military and economic security weakened. As my colleagues on this panel have pointed out, the projected increases in consumer demand, supply requirements, and capital needs clearly demonstrate that now is not the time to experiment with the depletion rate.

Under Secretary Walker has observed that the proposed change relating to income from tax exempt securities has made investors in that market "skittish," with the result of market impact out of all proportion to the proposed change. He said,

"... it can be viewed as a direct taxation for the first time of state and local government securities, which would cause investors to worry that greater taxation, full taxation, might take place at a later date. So that in purchasing securities today they would be skittish about the possibility of the rug being pulled out from under them later. It is the toe in the door argument, and it has its effect on markets, there is no doubt about it."

The proposed reduction of the rate to 20 percent would similarly have a more dampening effect on the industry's exploration efforts. It should be recognized that the psychological impact of such a reduction would cause oil and gas producers to be apprehensive about further reductions later, and these apprehensions would be reflected in greater reductions in expenditures for exploration and development.

Mr. Dunlop has pointed out that industry submissions to the Cabinet Task Force on oil import controls indicate that a one dollar per barrel reduction in the price of crude oil would make virtually all exploration in the United States uneconomic. Reduction of the depletion allowance to 20 percent would be equivalent to a price reduction of about 20 cents per barrel. If we were to make a simple interpolation between the effect of a 20 cent price cut and a one dollar cut which eliminated exploration, one might anticipate that the proposed reduction in depletion would reduce exploration by one fifth ($20¢ \div 100¢ = 1/5$)—assuming that the rate decrease were not offset by a price increase.

I feel certain that this is a conservative estimate of the importance of the rate decrease provided in H.R. 13270. Petroleum explorers would find themselves in precisely the same position as the municipal bond buyers referred to by Under Secretary Walker. The toe would be in the door of change in petroleum tax incentives. And a half century of faith in stable tax treatment of the industry would have been breached. Under these conditions, we can only predict that explorers' expectations about future tax treatment would be gravely and adversely affected. They would ask, "What tax increase next?"

The result would be a reduction in exploration greater than any decrease indicated by a direct evaluation of prospects which would appear uneconomic with a 20 cent lower price. Furthermore, *other* reductions in petroleum tax incentives—added to a 7½ point depletion rate reduction—would make exploration still less attractive.

This Committee was told by the Secretary of the Treasury that reducing the depletion rate to 20 percent probably would not make a substantial change in exploratory drilling activity. The Treasury Department of the previous Administration expressed a similar view which was based primarily on a study made by CONSAD Research Corporation.

The principal conclusion of the CONSAD study is that *elimination* of percentage depletion and of the option to expense intangibles would result in a maximum petroleum reserve reduction of only 7 percent. From this the Treasury concluded that annual exploratory and drilling expenditures would be reduced by only $150 million per year, even though the tax increase to the petroleum industry would be $1.6 billion per year. Simply on the grounds of common sense, it is obvious that reducing profits of oil companies by $1.6 billion would have a far greater impact on new expenditures.

There are many flaws in the CONSAD study. These are outlined in Attachment A. The principal error which makes the study irrelevant is that the economic model used in the study assumes that there is no relationship between the level of crude oil production and industry profitability. This is, of course, nonsense and no credence can be given to the study.

Many billions of dollars have been invested in the oil business in good faith reliance on the tax incentives that have been provided in the tax law for over a half century. To arbitrarily reduce the percentage depletion on past discoveries at this time would raise a question of the government's good faith. For example, the oil industry has paid $3 billion to the Federal and state governments for mineral leases in the waters of the Gulf of Mexico and in addition has spent more than twice that amount in exploration and development in this offshore area during the past 23 years. Total industry expenditures for domestic exploration and development have averaged about $4.5 billion annually during the past decade. All these expenditures have been based on the assumption that long-standing tax provisions would be continued.

The percentage depletion deduction is designed to recover the capital value of oil in the ground. At today's price of crude oil, this deduction provided by the full 27½ percent falls short of the value of net reserves as measured by the sales price of proven properties.

Production payments

The second provision of H.R. 13270 is the proposal to treat production payments as loans. Oil and gas operators have to rely primarily on producing properties to provide the security needed to obtain additional financing. The treatment of reserved production payments as loans will cause a reduction in value of 15 percent to 20 percent. This reduction decreases the funds available to independents thus impairing their ability to continue in the business of exploring for and developing oil and gas reserves.

According to Treasury estimates, this proposal will initially generate additional tax revenues; but these estimates may not take into account the loss of revenues that would result from discouraging sales of producing properties.

Allocation of deductions

The third provision of H.R. 13270 that will hurt the individual independent operator in his efforts to obtain needed capital is the one which would reduce his otherwise allowable nonbusiness deductions solely because he claims legitimate business deductions for his intangible drilling costs and percentage depletion. Examples of these nonbusiness deductions are interest, taxes, casualty losses, charitable contributions, and medical expenses. This proposal would tend to restrict the effectiveness of percentage depletion and intangible drilling cost deductions as incentives to invest the huge amounts of money needed to supply our petroleum needs. It will be a back-door subversion of such incentives.

Tax treatment of oil shale

H.R. 13270 retains the present rate of depletion for shale oil. It also recognizes that retorting of oil shale is a mining process. This properly takes into account the fact that the retorting of oil shale is essentially a process that separates the kerogen from the rock waste. The kerogen, which represents about 11 percent of the total volume of rock shale, must then be upgraded by coking and hydrogenation to process it into a crude petroleum.

This provision clarifies existing tax law and is desirable because depletion on the kerogen extracted from the rock shale is necessary if this important natural resource is to be developed.

TREASURY DEPARTMENT PROPOSALS

On September 4 and 5 the Treasury Department made two recommendations to your committee which would impose additional taxes on oil and gas producers. These recommendations would:

1. Include percentage depletion in determining the "limit on tax preferences" in all cases and include intangible drilling costs where less than 60 percent of the taxpayer's gross income is from the sale of oil and gas.
2. Tax as ordinary income gains on sales of mineral properties to the extent of intangible drilling costs previously deducted.

Limit on tax preferences

The Treasury Department's recommendation to include percentage depletion and intangible drilling costs in computing the "limit on tax preferences" (LTP) should be rejected.

On the first examination, the idea of LTP may have some appeal as a means of preventing escape from Federal income taxes by wealthy individuals. But on mature consideration it is questionable whether the basic concept of LTP is sound. The provisions for (1) exemption of municipal bond interest (included in LTP in the House bill but not in the Treasury proposal), (2) treatment of capital gains, (3) percentage depletion and (4) intangible drilling costs were written into the tax law after thorough analysis and evaluation by the Congress. They have been frequently reconsidered by many different Congresses and have been retained because there is good reason for them. The LTP approach, in effect, disallows almost 50 percent of these deductions for a limited number of taxpayers without consideration of the merits of the respective deductions. Actually, the proposal hurts those most who respond best to the incentives.

The Treasury Department's proposal, with its 60 percent rule, would be especially burdensome on the small independent producer even though he may not be personally subject to the rule. Many small producers depend heavily on suppliers of outside risk capital who would be affected by the proposal. If an investor cannot deduct all of his intangible drilling costs, his investments will obviously be curtailed. This would dry up an important source of capital for independent operators.

The Treasury Department stated last January that 154 individuals with adjusted gross incomes of more than $200,000 paid no Federal income tax in 1966. This statement has been given wide publicity and has been used to imply that percentage depletion was an important factor in these 154 individuals escaping taxation. On April 22, 1969, the Treasury Department revealed, however, that percentage depletion amounted to less than 1 percent of the total deductions which resulted in their paying no tax. Percentage depletion was so insignificant that the Treasury Department did not categorize it as a "major tax reducing factor."

Taxation of gains on sales of mineral properties

The Treasury Department has proposed that gains on sales of mineral producing properties be taxed as ordinary income to the extent of intangible drilling costs which have been allowed as deductions.

Adoption of this proposal would substantially reduce the real value of mineral properties. Consequently, it would make investment in exploration and development ventures less attractive at a time when there is a vital national need to make it more attractive.

This new proposal to tax gains on sales of properties as ordinary income is even more damaging to the industry's property values than is the proposal to treat production payments in ABC deals as loans. The combination of eliminating ABC deals and also imposing ordinary tax rates on gains from property sales would apply an "over-kill" technique which would create almost impossible obstacles to sales of mineral properties.

OTHER PROPOSALS

Other changes have been proposed that would reduce tax incentives for oil and gas producers. Three of these changes are (1) "plow-back" of depletion deductions, (2) capitalization of intangible drilling costs of development wells, and (3) graduated depletion rates. Each would reduce the incentive to develop domestic mineral reserves; hence, each is a threat to national security.

"Plowback" proposal

Under this proposal, producers would be permitted a 27½ percent depletion rate if they spend an equal amount in domestic exploration and development. The proposal is based on the false assumption that exploration and development expenditures are less than the industry's depletion deduction. The industry spent about $4.5 billion annually during the last ten years on exploration and development—almost twice the amount claimed for depletion. In addition to this false basis, the proposal has other defects:

1. The prospect of percentage depletion is, in part, what motivated the producers to explore for and develop the oil properties that are being depleted. Assistant Secretary Cohen correctly characterized depletion as a reward. He said, "If you are attracting capital for exploration, and a lot of capital is needed for exploration in oil and gas . . . it is difficult to get it from people if the incentive is given only so long as they keep their money invested constantly in exploration. If they cannot withdraw it, if the capital is not mobile, it will be difficult to raise."

2. If the depletion deduction is to be based on future exploration and development, then inevitably a producer's expenditures for exploration and

development will be influenced by and scheduled according to the amount of depletion that needs vesting. He may not be inclined to spend any more in a particular year than is necessary to cover the year's depletion even though he has attractive prospects. On the other hand, a producer who has not invested enough could make additional expenditures at no after-tax cost and would probably make additional expenditures even though his prospects were inferior. Thus, the "plow-back" requirement could induce one producer to spend money on inferior prospects and at the same time delay another producer from drilling prospects more likely to be productive. These are the dangers inherent in any subsidy approach.

3. Diluting the depletion incentive will deter others from entering the natural resource business, especially since those already in the business who have excess depletion would have lower costs of exploration and development through the vesting of past depletion. The natural resource industry in the United States, as a result, could become concentrated in fewer producers.

Many mineral producers have borrowed substantial amounts of money and have made firm and binding commitments for repayment. Some of these producers would be unable to repay these loans and also to maintain exploration and development expenditures high enough to satisfy "plow-back" requirements. As a result, those producers would lose a part of their depletion deductions; their tax payments would increase; and their ability to repay their present loans or to borrow money in the future would be impaired.

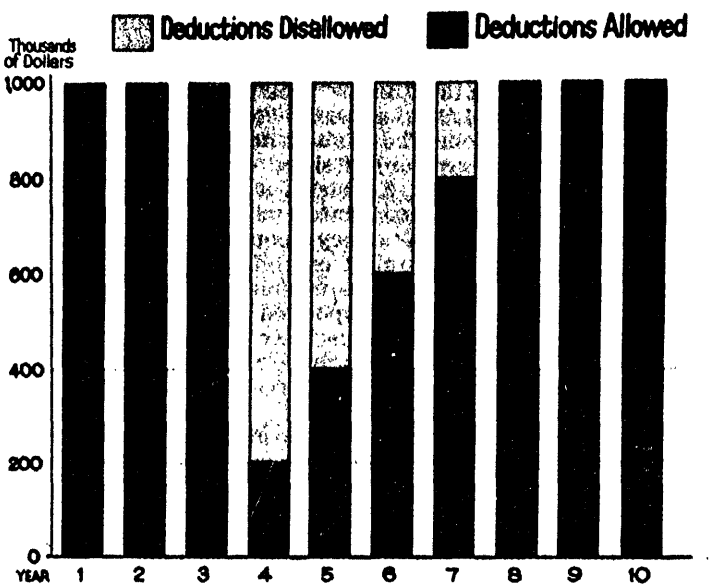
Capitalization of intangible drilling costs of development wells

The proposal to remove the current option to either capitalize or expense the intangible costs of drilling oil and gas wells is apparently based on the false assumption that taxes will be increased. Capitalization of these intangible costs will not ultimately increase taxes. It will merely change the timing of deductions. Deductions that can now be taken in the current year will instead be taken piecemeal over a period of years—the total deduction does not change.

The result of the proposal will be a serious disruption in funds available for exploration and development. The consequence will be a serious discontinuity in the finding and development of petroleum reserves in relation to the discontinuity of available deductions as shown by the example in Exhibit II. The resulting reduction in available funds would force small independent producers to withdraw from the industry. Using Exhibit II as an example, allowable deductions would be reduced $2 million over four years which, at a 50 percent tax rate, would reduce available funds by $1 million.

Exhibit II

Deductions disallowed if intangible drilling costs are capitalized



ASSUMPTIONS: 1. Annual Expenditures of $1 million
2. Capitalization Beginning in 4th year
3. Amortization over Five years

Percentage depletion at graduated rates

Proposals which advocate percentage depletion rates on a graduated scale according to the taxpayer's gross income are based on the false assumption that the industry is dominated by a few large companies. The industry actually consists of some 12,000 business firms with the four largest accounting for only about 24 percent of net domestic production, and twenty-three largest for only about one-half. This is a low degree of concentration when compared to other basic industries in the country.

One such proposal would change the depletion rates as follows:

Gross income	*Depletion rate (percent)*
$1,000,000 or less	27½
$1,000,000–$5,000,000	21
Over $5,000,000	15

The net effect of such a proposal would be to reduce percentage depletion for the industry as a whole to an effective rate of little more than 15 percent. Such a proposal would "punish" those who furnish the bulk of the nation's energy supply. Such a proposal would also reduce the incentive for a small company to grow larger. Penalizing success will not sustain the strong and viable petroleum industry needed to supply the energy requirements of our country.

The present tax law grants an exemption from the surtax for all corporations on the first $25,000 of taxable income. Large individual operators already are burdened by a progressive system of tax rates. To impose progressive depletion rates would double up on progressivity in a most inequitable manner.

In fact, the inequity of the graduated depletion type of progression is most obvious in the case of property owned jointly by a large company and a small independent producer. There is no more reason for this proposal than there would be for disallowing half of a large company's depreciation charges while allowing smaller operators the full deduction. After all, the value of oil in the ground is the same for all producers, regardless of size.

Moreover, the inherent risks in exploration are the same for large and small operators, all of whom have essential roles in the search for new petroleum deposits. No company is large enough to avoid these risks because: (1) they cannot participate in enough exploration ventures to be sure of achieving a success ratio equal to that of the entire industry; and (2) the size of any discovery in relation to its cost is unpredictable. Furthermore, we should not forget that while a corporation may be large, the ultimate taxpayers, in effect, are the many stockholders who in many cases hold relatively small amounts of stock in these large corporations.

SUMMARY AND CONCLUSIONS

While we know that the origin of the 27.5 percent oil depletion rate was one of compromise, we also know that Congress, in compromising at a level higher than any other extractive rate, recognized the unusual financial risks associated with oil exploration. These risks have not diminished. To the contrary, current conditions of exploration, offshore operations, and now the Arctic ventures all reaffirm, if not magnify, the risks.

As the financial risk associated with oil exploration has, if anything, increased, so has our national dependency upon oil, in terms of security. Through the years, the Congress, in continuing established incentives, has reaffirmed that the oil industry must supply the requirements of the nation under all conditions. The financial community has responded to the rewards offered, and the oil industry has utilized the capital effectively, as evidenced by our present national self-sufficiency in oil. This Committee must realize fully that an about-face in exploration activity and national security would occur if the various proposals discussed were implemented.

One other aspect of these proposed actions also troubles me. In preparing for this panel, in reviewing the proposed tax law changes and the published commentary and debate concerning them, I have detected something that cannot be analyzed or discussed in terms of economics or barrels of petroleum supply. Whatever it may be called, it is to me something completely alien to our form of government and our free enterprise system.

As applied to the oil industry, it indicates a desire on the part of many to "punish" the industry for being successful. It does not regard the success of the oil industry as the aggregate success of millions of employees, stockholders and property owners. It seems to disregard the success of the industry in enabling the United States to have the highest per capita consumption of energy in the world.

I believe that our industry is fulfilling its obligation to supply energy for this country at a price which has led to 75 percent reliance upon oil and gas and, concurrent with it, the greatest degree of industrialization of any country in the world.

ATTACHMENT A

THE CONSAD REPORT ON THE INFLUENCE OF U.S. PETROLEUM TAXATION ON THE LEVEL OF RESERVES

The conclusions of the CONSAD report can be given no credence because:

I. The mathematical formula (an "economic model") from which the conclusions are drawn is conceptually inappropriate for the purpose.

II. CONSAD, itself, issues repeated warnings about the pitfalls of its model-building. The combined impact of these cautions is a clear signal that CONSAD should have rejected this model, as it did two other models—and as it did *this* one for natural gas.

III. The quality of the data used in the formula is questionable, as is the method of manipulation.

IV. There are factual errors in the report.

V. The study proceeds from a number of doubtful premises about the economics of the petroleum industry.

I. *Inappropriateness of the CONSAD Formula*

The CONSAD study employed mathematical methods to predict the change in petroleum reserves that would result from elimination of percentage depletion. A fundamental error was made by using a formula that cannot answer this question. It was assumed that *production would not change* in the event of an increase in petroleum taxation, and the formula was designed to determine the level of reserves that would be required to accommodate the assumed fixed level of production.

Once it made the assumption that output is fixed regardless of profitability, it was inevitable that CONSAD would find that there would be little change in the desired level of reserves, since the required level of reserves is technologically determined by the level of production. It is indisputable, owing to the nature of petroleum deposits, that any given level of production requires a supporting amount of reserves which is a multiple of production—as CONSAD acknowledges on page 7.3 of the report. (To produce one barrel of oil annually, there must be about ten barrels of supporting reserves in the ground.)

CONSAD actually ignored the *real* problem, which is how the long-run level of output would change in reaction to a decrease in profitability resulting from increased taxation. Instead, CONSAD indefensibly assumed that the desired level of production is independent of the level of profitability of the industry.

Indeed, the CONSAD model makes no provision for unprofitability (except at a zero price of crude oil). The mathematical model is so formulated that it tells us that the industry would find and develop reserves even if price were less than cost. Any model which states that businessmen desire to invest when price is less than cost is indefensible because no firm desires to invest at a loss.

II. *CONSAD cautions*

CONSAD raised such an extended and serious list of objections to its own procedures that the reader should be convinced of the mathematical formula's lack of merit without further independent inquiry.

The formula was developed for use in describing the behavior of individual firms in manufacturing. CONSAD questioned whether the formula would be reliable if extended to the petroleum industry—see page 6.31.

CONSAD also questioned whether the historical data employed can be used to predict the future—see pages 6.12 and 6.13. In the report, it was said that "If the quantity of reserve necessary to support a certain level of output has changed during the period of the study, it will cause errors" in the estimates—page 6.13. (In fact, the ratio of proved reserves to production actually *has* declined steadily since 1960.)

CONSAD warns that reliable economic models require reliable data. In addition to the problem of finding reliable figures, it was recognized that there are massive problems in using the data. Perhaps the best example is finding costs.

"the most ambiguous area in the data in this study"—page 6.16. Computing industry finding costs involves multiple difficulties, e.g., (a) the impossibility of determining from industry data when the exploration dollars for a given year's discoveries were actually spent; (b) the difficulty of estimating how much has been found until a number of years after discovery; and (c) the random variability of the amount spent per barrel found from year to year.

III. *Statistical problems*

The CONSAD report points out that there are "many missing links" in the quantitative data available for making a reliable economic study—page B.1. It nevertheless proceeded with the study on the basis of estimated data and often relied on doubtful stand-in data to estimate the effects of important items for which it could not obtain direct information. Moreover, the data were used to predict the effect of a change in industry taxation for which there is no historical precedent. Such an extrapolation beyond the range of historical experience violates fundamental statistical principles.

IV. *Incorrect information*

The report contains factually incorrect statements. Some involve data—even matters as basic as the current level of U.S. crude oil production. Others refer to petroleum tax provisions which do not exist.

If a research company is so unfamiliar with the petroleum industry as to err on basic data and tax provisions, it is unlikely to have sufficient knowledge of the industry to be able to develop accurate complex mathematical models for analyzing industry behavior.

V. *Doubtful petroleum economics*

Some of the premises of the CONSAD study are, in our opinion, based on unreliable assumptions about the economics of the industry. A notable example of these propositions asserts that Canadian crude reserves can "substitute" for United States reserves. However, the amount of crude oil imports from Canada is limited by agreement between the two governments. Since crude oil imports from Canada are controlled, Canadian reserves—like overseas reserves—are not substitutes for U.S. reserves. Thus, CONSAD should not have aggregated Canadian and U.S. reserves in its economic model. And drawing conclusions from this model entailed the error of assuming that changes in the U.S. tax law would have the same effect on Canadian reserves as on domestic reserves.

Conclusion

No useful conclusions can be drawn from the CONSAD study because the mathematical model and the data are defective and because some of the basic premises are not appropriate. Indeed, it was predestined that CONSAD's exercise would be futile because CONSAD assumed that production would not change in the event of an increase in petroleum taxation.

Furthermore, we firmly believe that *no* aggregative mathematical mode of the oil industry—no matter how sophisticated—can be used as a guide to estimating the effects of eliminating percentage depletion. Two of the most important reasons for this are:

(1) Part of the period upon which such a model must be based (the 1950's and 1960's) was one of industry readjustment to excess capacity, a readjustment now well on the way to completion. Sound statistical theory holds that projection of a past period assumes that any changes that occurred in the base period will be repeated in the future. Since further significant adjustment to excess capacity is not likely, the 1950's and 1960's cannot be used as a base for forecasting the future.

(2) The largest year-to-year crude oil price change since 1950 was +30¢ per barrel (1956 to 1957). Elimination of percentage depletion would be equivalent to a price reduction of about 75¢ per barrel. Thus, any prediction of the results of such a tax change based on a model reflecting the 1950's and 1960's would require extrapolation far beyond the limits of the base period data.

Sound statistical theory holds that such extrapolation is invalid because there is simply no historical basis for evaluating how firms would react to changes so far beyond the range of experience.

CONSAD admitted the existence of these problems, but it proceeded undeterred.

Our criticism is not so much that CONSAD's exercise predictably proved futile, as that CONSAD drew serious public policy conclusions from its mathematical

model despite the obvious and admitted statistical problems involved in constructing any such model. The model used is especially subject to criticism because it is based on the improper assumption that industry exploration and development expenditures are not dependent on an adequate rate of return.

The CHAIRMAN. The next witness will be Mr. H. A. True, Jr., speaking for the Independent Petroleum Association of America, and Mr. Clinton Engstrand, chairman of the Liaison Committee of Cooperating Associations.

With these two witnesses will be representatives of the independent oil and gas producers of California: the Independent Oil Producers and Land-Owners Association, Mr. D. F. McKeithan, Jr., Kansas Independent Oil and Gas Association, Tom Schwinn, executive vice president and counsel, Oklahoma Home and Independent Petroleum Association, Mr. William B. McCleary, Panhandle Producers and Royalty Association, Mr. C. H. Hinton, Texas Independent Producers Royalty Owners Association, Mr. William J. Murray, and West Central Texas Oil and Gas Association, Mr. A. V. Jones.

Senator HANSEN. May I be permitted to add my personal word of welcome to Mr. Dave True, a longtime friend of mine. He has discharged a great many distinguished responsibilities with distinction to himself and the benefit of my State of Wyoming. He is president of the university board of trustees and, which I suspect he will confine his testimony today to questions pertinent and relevant to the oil business, I might also add that he has a very real interest as I know from personal knowledge of him in other facets of this total tax package, and I am pleased indeed and proud to welcome my fellow Wyomingite, Dave True, to this panel today.

The CHAIRMAN. There are some charts that the witnesses have and I will ask that they put them up here so the audience will see them.

Senator Pearson.

STATEMENT OF HON. JAMES B. PEARSON, U.S. SENATOR FROM KANSAS

Senator PEARSON. Mr. Chairman and members of the committee, taking into account the comments of the chairman and the size of this record, I am intimidated enough so I am going to make a very brief introduction of some outstanding men of the State of Kansas of the independent oil and gas industry.

I should like to introduce Mr. Clinton Engstrand, chairman of the Liaison Committee of Cooperating Associations and in addition thereto to introduce Mr. Hoover and Mr. Carl Sebits.

Mr. Hoover is president and Mr. Sebits is vice president of the Kansas Independent Oil and Gas Association.

The testimony this morning, Mr. Chairman, will be presented by Mr. Tom Schwinn, executive vice president and counsel.

I thank the chairman of the committee very much.

Senator HARRIS. I want to note the presence of Bill Cleary, president of the Oklahoma Independent Petroleum Association in Oklahoma, a man that I have found very easy to work with. He represents an association which speaks for an industry of tremendous importance to us in our State. We are privileged that he is here to speak for that association.

The CHAIRMAN. I do not see any Louisianian, but I am happy to see someone speak for the independents. We have a few left in Louisiana.

Proceed.

COORDINATED TESTIMONY OF INDEPENDENT OIL AND GAS PRODUCERS

STATEMENTS OF H. A. TRUE, JR., TRUE OIL CO.; CLINTON ENGSTRAND, CHAIRMAN, LIAISON COMMITTEE OF COOPERATING OIL & GAS ASSOCIATIONS; STARK FOX, EXECUTIVE VICE PRESIDENT, INDEPENDENT OIL AND GAS PRODUCERS OF CALIFORNIA; D. F. McKEITHAN, JR., PRESIDENT, INDEPENDENT OIL PRODUCERS & LAND OWNERS ASSOCIATION, TRI-STATE, INC.; TOM SCHWINN, B.S., LL. D., J.D., EXECUTIVE VICE PRESIDENT AND COUNSEL, KANSAS INDEPENDENT OIL & GAS ASSOCIATION; WILLIAM B. CLEARY, PRESIDENT, OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION; C. H. HINTON, PETROLEUM CONSULTANT, PANHANDLE PRODUCERS & ROYALTY OWNERS ASSOCIATION; WILLIAM J. MURRAY, JR., PRESIDENT, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION; AND A. V. JONES, JR., PRESIDENT, WEST CENTRAL TEXAS OIL & GAS ASSOCIATION

Mr. TRUE. Thank you, Mr. Chairman, and thank you, Senator Hansen, for your kind remarks.

I am H. A. True, representing the Independent Petroleum Association of America, and 10 other State and local associations who could not be with us as representatives today.

They are as follows: Bradford District, Pennsylvania, Oil Producers Association; California Independent Producers & Royalty Owners Association; Kentucky Oil & Gas Association; Michigan Oil & Gas Association; National Stripper Well Association; New York State Oil Producers Association; Ohio Oil & Gas Association; Pennsylvania Grade Crude Oil Association; Southwestern Pennsylvania Oil & Gas Association; and the North Texas Oil & Gas Association.

In the judgment of the domestic oil and gas producers, the adequacy of future U.S. oil and gas supplies is seriously threatened by proposed changes in Federal tax provisions. In addition to proposals that would adversely affect all businesses, including the petroleum industry, there are many proposed changes that would directly affect U.S. oil and gas exploration, development, and production.

The changes in petroleum tax provisions approved by the House and the additional proposals made by the Treasury Department would not only decrease substantially the funds available for exploration and development, but also greatly lessen the incentive to make investments in this high-risk business.

The ultimate victim would be the consumer who would be faced with less oil and gas, higher prices, or both.

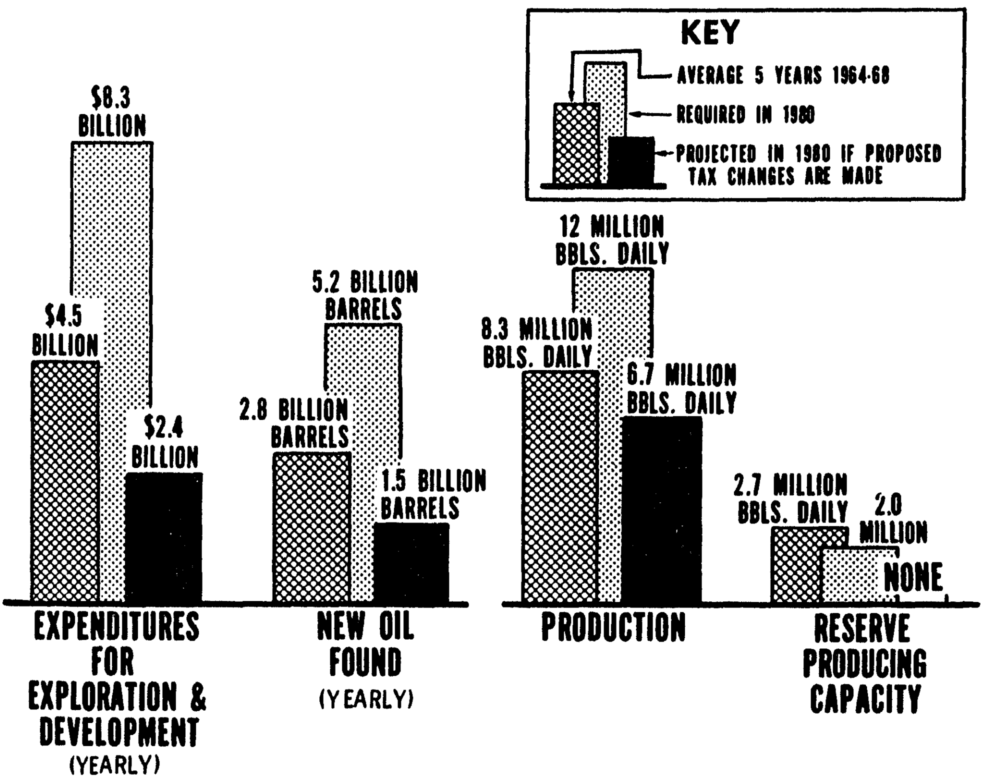
In the hope it will be helpful in your deliberations we submit our assessment of the overall long-range effect of adopting the proposed tax changes.

The results of our analysis are summarized on the chart before you now, which shows annual expenditures for U.S. exploration and development, total amount of new crude oil found yearly, the daily average domestic crude oil production, and the amount of reserve producing capacity.

In each case the first bar shows the average of the latest 5 years. The second bar shows the projected requirement for 1980. The third bar shows our projection of the situation in 1980 if the proposed changes in petroleum tax provisions are adopted.

You will note from the chart that the total expenditures for U.S. exploration and development would decline by about $2 billion or 47 percent from the level of the last 5 years.

U. S. CRUDE OIL SUPPLY



Expenditures in 1980 would total only $2.4 billion compared with the required expenditure of $8.3 billion, a deficiency of $5.9 billion or more than 70 percent.

At this point it should be noted that the proposed tax changes would have serious adverse effects upon expenditures and new discovery in the immediate future as well as in the long run.

In other words, it is estimated that about half of the $2 billion decrease from recent levels of expenditure would occur within the first 12 to 24 months, after the first tax changes were adopted. The decline in production would be less abrupt but equally serious. To assure adequate domestic supply with dangerous increased dependency on foreign sources, U.S. crude oil production should be expanded 12 million barrels daily by 1980.

This would be an increase of 3,700,000 barrels daily or about 45 percent over the average of the past 5 years. As a result of declining expenditure and less new oil found, however, production would decrease and fall far short of these requirements. The 1980 deficiency in crude oil production will result in imports supplying about 50 percent of the total U.S. requirements, with no U.S. reserve producing capacity. In fact, we would be increasingly and dangerously dependent on foreign oil in the very near future.

Senator ANDERSON. Could you state what those figures are? Where can we find those figures?

Mr. TRUE. We will submit a detailed statement of where these figures came from, of how we arrived at these conclusions.

(The following memorandum was subsequently received for the record:)

MEMORANDUM RE PROCEDURES USED IN ESTIMATING EFFECT OF PROPOSED TAX CHANGES ON U.S. CRUDE OIL PRODUCING INDUSTRY

This memorandum outlines the procedures used to assess the impact of the proposed tax changes on domestic crude oil supplies during the next ten years.

The assumptions and projections of U.S. petroleum requirements and supplies are based on a comprehensive study submitted by the IPAA on July 15, 1969, to the Cabinet Task Force on Oil Import Control. That study showed a growth in total U.S. requirements for petroleum liquids increasing from 14 million barrels per day in 1970 to 18.2 million barrels per day in 1980, an increase of 30 percent. Using the assumption that foreign oil imports would continue to supply approximately 20 percent of total U.S. requirements, estimates of required domestic crude oil supplies would increase from 9.5 million barrels daily in 1970 to 12.0 million barrels daily in 1980.

If the proposed tax changes affecting the U.S. crude oil producing industry were adopted, the impact on new oil found would be felt immediately due to lower available funds for exploration and development and progressively worsen so that, by 1980, estimated domestic supplies available would total only 6.7 million barrels daily compared with requirements of 12.0 million, or a shortfall of 5.3 million barrels daily. Further, after two years and continuing to 1980, U.S. production would be declining with no reserve available for emergency use.

Exploration and Development Expenditures

The proposed tax revisions would substantially decrease the retained funds available to producers for exploration and development activities because of additional taxes. Further, proved reserves in the ground not yet produced would fall in value. Third, and perhaps of equal or greater significance, such tax changes unquestionably would have the psychological effect of further substantial reduction in the incentive to invest capital in the high-risk business of new oil and gas exploration.

The proposed reduction in percentage depletion from 27.5 to 20 percent, coupled with the extension of the surtax, repeal of the investment tax credit, and the change in treatment of capital gains, are estimated in the aggregate to reduce both the funds available for exploration and development by the larger units of the oil producing industry and the incentive to risk capital. As a result, total expenditures for U.S. exploration and development by larger companies are estimated to decline by about 20 percent within the first 12 to 24 months following the adoption of the proposed tax changes.

Since other tax proposals would affect primarily the independent producer, (the treatment of production payments as loans, the allocations of deductions which could make percentage depletion and intangible drilling cost deductions less effective, inclusion of depletion as a "tax preference" for individual operators, limitation on expensing of intangible, or non-recoverable expenditures, by inclusion as a "tax preference" for individual operators that obtain less than 60 percent of gross income from the sale of oil and gas, and the taxation of ordinary income, under a "recapture rule" on the sale of oil or gas properties to the extent of intangible drilling costs previously deducted) the impact of all the proposed tax changes on the independent producer's funds and incentives would be far greater than the estimated 20 percent reduction for larger companies. We estimate, in the aggregate, a 40 percent reduction in expenditures for exploration and development activities by individual independent producers in the 12 to 24 months following adoption of the proposed tax changes.

These short-range effects of adopting the proposed tax changes may be summarized as follows:

TOTAL EXPENDITURES, U.S. OIL AND GAS EXPLORATION

[In millions of dollars per year]

	Actual 5 years 1964-68[1]	Estimated within 12 to 24 months after adoption of tax changes	
Larger companies	3,200	2,560	−640
Independents	1,300	780	−520
Total	4,500	3,340	−1,160

[1] Data from Chase Manhattan Bank.

Further erosion over the years in the funds available to the industry for exploration and development would take place because crude oil production would reach capacity within three years and decline steadily thereafter. An annual decrease of 5 percent is projected in funds expended for exploration and development activities from that time through 1980 due primarily to declining annual production volumes of crude oil.

New Oil Found

Since exploration and development expenditures are estimated to decline in the aggregate (larger companies plus independents) by 26 percent from year earlier levels in the year following change in the tax provisions, a similar 26 percent reduction was estimated for new oil found from your earlier levels. Beginning with the year when production is estimated to equal capacity to produce, new oil found was estimated to decrease 5 percent annually in concert with a similar percentage decrease in funds available for exploration and development.

Crude Oil Production

Currently the U.S. reserve capacity to produce crude oil amounts to approximately 2 million barrels daily. Thus, crude oil production could increase for a few years by drawing upon the reserve producing capacity in being even though smaller volumes of new oil were found annually than in the past due to a reduction in exploration and development expenditures. This situation would exist for only two years before production volumes equalled capacity to produce with no reserve capacity available.

Accordingly, our evaluation indicates that crude oil production could increase during each of the first two years following changes in the tax provisions by 2.5 percent and 3.7 percent respectively. In the third year, crude oil production would be equal to capacity since rising oil production in excess of new oil found during the preceding years would eliminate the reserve producing capacity available currently. In the third, and subsequent years, with new oil found declining 5 percent per year and production at capacity levels, crude oil production would begin to decrease annually and average only 6.7 million barrels daily in 1980 with no reserve capacity available. The deficit of 5.3 million barrels daily would constitute an additional import volume over current levels.

Proved Reserves

Lower volumes of new oil found due to the reduction in retained funds available for exploration and development coupled with larger volumes of crude oil production during the first two years after the proposed tax revisions were effected would eliminate reserve producing capacity and result in lower crude oil reserves as well. Proved domestic crude oil reserves would continue to decline each year thereafter in line with smaller and smaller volumes of new oil found in harmony with decreased spending for exploration and development. Crude oil reserves in 1980 would total only 19 billion barrels compared with required reserves of 40 billion.

Year end proved crude oil reserves were calculated by adding new oil found to the previous year's proved reserves and subtracting annual production.

Producing Capacity

Reserve producing capacity is a function of proved reserves and actual production. Crude oil productive capacity in January 1969 was 11.1 million barrels daily, compared with actual production of 9.2 million barrels daily, or a reserve capacity to produce oil from existing wells of 1.9 million barrels daily. The ratio of reserves to capacity during the period 1964–68 was 7.8 (31.2 billion reserves divided by 4.0 billion barrels annual production capacity).

Crude oil producing capacity for each year through 1980 was arrived at by dividing year end reserves by 7.8. The reserve crude oil producing capacity for a given year was arrived at by subtracting estimated crude oil production from the crude oil producing capacity total.

Mr. TRUE. This would be an intolerable situation from the standpoint of both national security and the maintenance of peace in the free world. Russia would be the only major world power in the position of self-sufficiency as to essential petroleum supply: the United States would have lost its posture of strength in petroleum and would become subject to the political pressures and demands of producing countries of the Eastern Hemisphere.

It should be emphasized that independent producers would bear the primary and most damaging impacts of some of the proposals, including the improper inclusion of percentage depletion and intangible drilling costs in the LTP proposal and the virtual elimination of one of the most important means of financing operations through carved-out production payments and ABC sales transactions.

The True Oil Co. by the way has sold several carved-out oil payments. This has been done for one purpose and one purpose only, to finance drilling obligations. It has been my experience that independent producers generally use carved-out oil payments and ABC transactions to raise needed funds, and not for tax purposes.

If the proposed tax changes were adopted, many independent producers, including our own operation with its 300 employees, would be forced to liquidate their properties and discontinue exploration and development activity.

Competition in the domestic producing industry and the multiplicity of effort has been a key factor in the discovery of new reserves and would be seriously reduced.

It is our firm belief that the proposed tax changes would result in a declining domestic petroleum industry, greatly reduced tax revenues in the oil industry for many hard-pressed local and State governments, less income to manufacturers, servicing companies and allied businesses, and in the final analysis less and not more Federal tax revenues.

In conclusion, we respectfully urge that the following additional considerations be taken into account by your committee.

First. A healthy expanding domestic industry has provided the assurance of adequate supply of both oil and natural gas, and would be the best assurance for the future.

It should be kept in mind that the efficiency of the domestic industry has provided petroleum energy—the producer's average price of both oil and natural gas combined—at a cost of less than $1.90 a barrel as compared with over $2 per barrel for imported oil. There is no saving or safety in relying on foreign oil.

Second. The domestic industry's activities in searching for and developing U.S. petroleum resources have declined to inadequate levels, imperiling the Nation's economic progress and future security.

Assurances of adequate oil and gas supplies to meet future requirements requires much more, not less, domestic exploration and drilling.

Third. The search for new reserves of oil and natural gas is interrelated and inseparable. Natural gas is already in short supply, and the proposed changes in tax revisions would aggravate and intensify the existing critical situation as to gas supply.

Fourth. To offset the effect of the proposed tax changes, and assure adequate supplies of both oil and gas, the alternative would be increased prices that would cost the consuming public billions of dollars annually.

Fifth. Governmental decisions as to the Federal tax revision and import policy will determine whether the historical position of the U.S. self-sufficiency and indispensable petroleum supply will be preserved or whether the United States will embark on a course knowingly leading to insufficiency and dangerous dependency on foreign sources.

Thank you.

Senator HANSEN. Mr. Chairman, may I ask one question?

Senator ANDERSON. Go ahead.

Senator HANSEN. I have often heard the inference made that oil producers pay no or little Federal income tax. What is your experience in that regard?

Mr. TRUE. Senator Hansen, I have been in business for 21 years. I have personally paid income tax each of these 21 years and, in addition, our total operations have paid substantial amounts of Federal income tax over these years.

To put it in perspective, I think we have paid about nine times as much income tax as my family and I have personally withdrawn from our business.

Senator CURTIS. Mr. True, were you in the room a few minutes ago when I asked about the effects upon a State such as Nebraska, with a very small oil industry if the House bill passes?

Mr. TRUE. Yes, sir; I was, Senator.

Senator CURTIS. I would value your opinion because Wyoming is an extension of the Panhandle of Nebraska. We are very fond of our neighbors. What do you think the enactment of the House provision would do to our rather small, very small oil industry in Nebraska?

Mr. TRUE. Senator, I believe I could possibly elaborate a little by looking at the chart. The expenditures as you see under these provisions we estimate to go down $2 billion, and certainly the oil industry as a whole is going to look for the very most prolific areas in which to spend the reduced exploratory funds.

Senator CURTIS. In other words, the marginal areas will be hit worse than those that there is good reason to believe would provide quite rich and sustaining yield?

Mr. TRUE. That is correct, and your State as well as mine are kind of out on the end of the main pipeline system, and this gives us another disadvantage already. In other words, our transportation costs to the main markets are higher.

Senator CURTIS. Thank you very much.

Senator HARRIS. Mr. Chairman, I want to ask Mr. True a question. You indicated the high risk involved in the industry, and I wondered if from your own personal experience you might give some further elaboration on that point?

Mr. TRUE. With your permission, Senator Harris, I will give the worst first and the best last. During these last 3 years we have participated in 68 oil wells, not exploratory oil wells but total oil wells. Out of that 68, we drilled 64 strictly dry holes. We have drilled three subcommercial producers which will probably not return the cost, and we have drilled one infield well primarily for secondary recovery purposes, so our success ratio has been terrible and it certainly substantiates the risk ratios that the former panel was talking about.

On the other hand, we went through a period prior to this 3 years where we discovered several not significant but for our country satisfactory oilfields in this same area, and it was at that time that some referred to us as the lucky oil company, because we did have a good series of success.

What I am trying to say, you have such tremendous peaks and valleys in finding oil, because you cannot tell what is there until you dig a hole in the ground.

Senator HARRIS. Thank you, Mr. Chairman.

Senator MILLER. Mr. True, are there both unincorporated and incorporated independents?

Mr. TRUE. Yes, sir.

Senator MILLER. Are there some independents either incorporated or unincorporated who gross over $1 million a year?

Mr. TRUE. This brings a pretty tough definition to mind--just what is an independent. There are some rather large incorporated companies that gross over $1 million a year, which have production alone.

Senator MILLER. Well, are there members of your association that gross over $1 million in sales?

Mr. TRUE. Yes; we have several members who gross over $1 million.

Senator MILLER. Are there any that gross over $5 million?

Mr. TRUE. Yes.

Senator MILLER. Because one grosses $6 million and another grosses $4 million, does it necessarily follow that the one that grosses $4 million has more net profit?

Mr. TRUE. No, sir; it does not necessarily follow.

Senator MILLER. Thank you.

Senator ANDERSON. You said that there are 68 wells and 63 of them were dry holes?

Mr. TRUE. Sixty-four were dry.

Senator ANDERSON. Were they dry holes?

Mr. TRUE. Yes, sir.

Senator ANDERSON. Who is your banker?

Mr. TRUE. I am a member of the board, Senator.

Senator ANDERSON. You cannot stay in business very long.

Mr. TRUE. That is true, Senator, but we had a successful period prior to this and frankly we are still living on our success of the early 1960's.

The CHAIRMAN. Do the other witnesses wish to make a statement?

Mr. TRUE. Yes. I think Mr. Clinton Engstrand has already been introduced, but he will take over from here.

Mr. ENGSTRAND. Thank you, Mr. Chairman and members of the committee.

I do not want you to be alarmed by this big panel because they have been instructed to be very short-winded. They have a few remarks to make and they will hold them very briefly. I am authorized to appear here as chairman of the liaison committee of the Cooperating Gas Associations and organizations consisting of representatives from 21 independent producer oil and services associations located throughout the Nation.

Our group range geographically from Alaska to the gulf coast and from California to Pennsylvania.

The producers we represent operate almost exclusively in inland areas of the United States and concentrate their activity and their exploration development and production segment of the domestic oil industry.

Consequently we seek national tax policies that encourage rather than discourage development of domestic oil reserves.

Independents operate as individual small partnerships or in venture combinations of small corporations. However, they do rarely incorporate, thereby maintaining the freedom required for well-drilling decisions, subject of course to veto by the bankers.

They are therefore highly vulnerable to any adjustment in current tax laws that offer them the incentives needed to drill.

There are several of the member associations who have representatives here at the table and I am going to call on them to make a short statement and then, when they have completed their short statement, I would like to have a couple of minutes to summarize if time permits.

So first I would like to call on Mr. Jack McKeithan. He is the president of the Tri-State Oil & Gas Association, composed of Indiana, Illinois, and Kentucky.

Jack, would you take over.

Mr. McKEITHAN. Thank you, Clint.

As Mr. Engstrand has said, I am from the tristate area of Illinois, Indiana, and Kentucky representing the Independent Oil Producers & Land Owners Association, whose membership is composed entirely of small independent oil producers and landowners located in those three areas.

Before I proceed, I would like to go on record on behalf of my association as supporting fully the other testimony to be given here today by the independent associations from throughout the country.

In our judgment their remarks are sound and accurate.

I want to confine myself to making a few statements to you gentlemen as to the possible effects of tax revisions on the industry in my area, because you may not know how significant what you do could be in its effect on us.

The oil industry to which I refer is almost exclusively composed of small independent producers, suppliers, and drillers. They are the same type of independent who has historically found 80 percent of our reserves. His usual operation is long on guts, short on capital, but nevertheless he manages to get out, drill, and search for oil. Normally he raises the principal portion of his exploration capital from investors outside the oil business, from men and women who can afford to risk capital on the 1-in-15 chance that he will find oil in our area.

Ironically, these same investors who provide the funds necessary to our small independents are now primary targets of this Congress in its effort to revise the tax structure.

The proposed revisions, if adopted, can only affect adversely those individuals and firms now engaged in our oil and gas industry. This consideration alone is not necessarily a valid reason for avoiding change. However, all the consequences of a tax change must be measured not only in terms of the immediate revenue expected to be realized but more importantly in the long-range effects to be expected in the overall impact on the economy and security of our Nation.

In our tristate area reduced depletion rates will seriously cripple our segment of the industry. This would result in a curtailment of employment, with the resulting loss in payrolls and taxes as well as the loss of oil production, and consequently the loss of royalties to our landowners and taxes to our counties.

If it can be recognized that a cut in the present depletion schedule would seriously cripple our tristate industry, it is even more apparent that a change in the manner of deduction of intangibles will literally, and we believe without exception, destroy our oil business.

We have over 1,500 small businessmen employing approximately 30,000 men and women who annually contribute a gross of about $400 million to our economy, which includes $30 million annually paid to landowners in the form of royalty, and over $6 million in taxes to the local county governments.

As noted, the proposed tax change will not render a temporary hardship upon these independents; such a change will virtually eliminate them as a contributing segment of our economy.

Our local economy would be unable to compensate for such a loss.

More important still, our country cannot afford to lose this segment of its domestic oil industry. Once it is lost, it is doubtful that even the reserves of the skilled technicians could ever be replaced.

In conclusion, therefore, I submit that the action of this committee will very definitely determine the future course of the independent in our area. Unfortunately the choice is not one of compromise. Our very livelihood depends on the actions you men take. Thank you.

Mr. ENGSTRAND. Next is Mr. William Cleary from Oklahoma, president of the OIPA.

Mr. CLEARY. Thank you, Clint.

In terms of the impact on my State—where as many as 40,000 jobs may be at stake—and perhaps on the Nation, the next 3 minutes may be the most important ones of my life. You will hear about Oklahoma independent producers, their impact upon the Nation's energy supply, and the effect of depletion on them.

Our State produces about 500,000 barrels of oil per day, roughly 6 percent of the Nation's total and about 7 percent of its natural gas. Perhaps more important, our operating area contains more than 10 percent of the probable undrilled reserves of natural gas.

For the past 2 years independents have drilled more than 85 percent of the exploratory wells in our State. Because the majors are devoting more and more of their budgets to offshore areas and Alaska, we expect to be responsible for even more of the drilling in the future.

Demand in our area is outrunning supply, even with existing prices and present tax incentives. We have not produced enough oil each month for nearly 2 years to meet the pipelines' demands.

The supply-demand situation in natural gas which particularly affects the Northern States and the eastern seaboard is even more critical, and I am sure that you all are aware of the precipitous drop in the reserve supply.

We are doing our dead-level best to attract capital to find new reserves with present incentives and we cannot keep up with demand. We need all the help we can get from you. More than 70 percent of our risk capital—that is our, the independent's, risk capital—comes from outside the industry in Oklahoma. The threat of tax changes has already caused a substantial drying up of that risk capital just in the past 2 months.

Mr. Jones will tell you of the importance of currently deducting nonrecoverable costs in attracting capital. Depletion is also important and I have a suggestion concerning it.

The depletion concept is sound. When we produce a barrel of oil, we have one less barrel of total reserve in the ground. You might think of us as an apple farmer who cuts off a limb with each apple he harvests, so that when the crop is complete he has no more tree.

The Congress has wisely said that the whole oil crop should not be considered income. A portion of the proceeds should be set aside as a seed crop free of tax liability so that our oil farmer can plant another tree and hopefully raise another vital crop. I can assure you that the risk of crop failure is extremely high.

Oil and gas percentage depletion is presently set at 27½ percent of gross income but is limited to 50 percent of net income. In Oklahoma this limitation accounts for the fact that independents get around 21 percent rather than 27½ percent. The restriction hurts us most when production becomes marginal and we need all the capital we can get for reinvestment.

We believe it is politically feasible to remove this restriction on percentage depletion. Such removal would help our incentives to explore for new reserves. We urge you to consider seriously the removal of the 50-percent net-income limitation when you consider all aspects of percentage depletion.

Thank you.

Mr. ENGSTRAND. Next on the panel is Mr. Charlie Hinton. He is representing the Panhandle Producers & Royalty Owners Association.

Mr. HINTON. I am a petroleum consultant. I live at Amarillo, Tex. For the past 33 years I have spent the major part of my time on the many problems related to natural gas supply and the requirements for natural gas. I am appearing here as a member and in behalf of the Panhandle Producers & Royalty Owners Association.

I have filed a formal statement with the committee detailing the supply of natural gas available to the consumers of America, anticipated needs in the future, and the effect of changes in the Texas laws on meeting those needs. I appreciate this opportunity to summarize within the few minutes allotted to me the situation facing our Nation with regard to natural gas which supplies a third of our total energy requirements.

I respectfully call your attention to these facts. Natural gas is a relative newcomer as a widespread source of energy, its use has grown tremendously since World War II. The householders and industry have demanded more and more natural gas because it is economical, it is adaptable to thousands of industrial uses, and it is clean. It does not pollute the atmosphere. This is of paramount importance today.

Within the past 13 years production of natural gas has almost doubled from 10.1 trillion produced in 1955 to 19.4 trillion cubic feet in 1968. But the available supply of natural gas has not kept up with demand.

In 1955 we had a reserve life index, the ratio of annual production to recoverable reserves, of 22.1 years. In 1968 this reserve life was only 14.8 years. This is for the ultimate recovery of those reserves, and it certainly does not mean that there will be a full supply of natural gas for 14.8 years.

The full supply, based on 1968 production, would only last for a period of 3 to 4 years. In 1968, for the first time in history, production of natural gas was greater than the new reserves discovered and developed. It is obvious that, if this trend continues, the Nation will run out of natural gas in the foreseeable future.

At the same time future gas requirements are estimated to increase to 25.5 trillion cubic feet in 1975, and 36 trillion cubic feet by 1990. I do not mean to imply that someone will go cold next winter for lack of natural gas or the winter thereafter, but I do say that, if proper steps, proper incentives, are not provided now, that there will be a natural gas crisis of shameful proportions in 5 to 10 years. That is because there is a timelag of several years after the first well is drilled before a new field is put into full production and gas from that field can be brought to the consumer.

Historically the natural gas industry has depended on the producer segment of the industry to find its supply. For many years oil well gas supplied a third of the Nation's gas requirements.

That has shrunk to 20 percent. The number of wells drilled has declined sharply from more than 57,000 in 1956 to just over 30,000 in 1968.

There are new gas reserves to be found. Present estimates are estimated at 287 trillion cubic feet. We estimate that there is an additional 1,200 trillion feet to be found, including 400 trillion to be found in Alaska, but this requires enormous outlays of money. It requires incentive and it requires the support of Congress.

National policy requires that the production of energy be stimulated, not retarded. One of the prime elements in our national economic progress, an essential ingredient of our standard of living, is adequate sources of energy. This is true of all industrialized, economically strong nations.

As Congress determines the direction in which we move, it occurs to me that assurance of adequate energy sources should be high on the priority list.

Gentlemen, this Nation runs on energy. Cutting incentives such as the depletion allowance or intangible drilling costs, which have played a vital part in providing that energy, will have a negative effect on the long-range interests of every American.

With regard to natural gas, which is in short supply right now, I hope that a few years from now this committee is not faced with debating how to stimulate production to meet national needs. For that reason I hope that you will support the present policy which has served this Nation well.

Mr. ENGSTRAND. Next on the panel is A. V. Jones, president, West Central Texas Oil & Gas Association.

Mr. JONES. Mr. Chairman and members of the committee, my name is A. V. Jones, Jr., and I am an independent oil and gas producer and live in Albany, Tex. I appear here today as president of the West Central Texas Oil & Gas Association as well as representing the members who belong to our association. I would like to present myself as an individual small businessman, widely experienced in oil exploration and development.

Gentlemen, we feel that the consuming public, and that means all the people of this Nation, has been well served by the petroleum industry. Few industries had supplied the consumer with continually improving products at essentially the same real price.

We maintain that any adverse tax legislation aimed at the petroleum industry will directly affect all consumers. To supply the energy needs of this Nation, most governmental and industry reports emphasize the fact that petroleum exploration must be increased substantially over the next few years.

Historically the independent segment of the petroleum industry explored for and found most of the domestic production. In other words, the necessary domestic exploration effort, the nonrecoverable costs of exploration and drilling known as intangibles, must continue to be recognized as essentially business expense for all participants in the oil and gas industry. There must be no limitation of any kind. All the nonrecoverable costs must be deductible when they are incurred.

Petroleum exploration is a very risky enterprise, and correspondingly there must be substantial profits to balance extensive losses. Many of the people participating in our business are successful, but most of them lose. These losers are a necessary part of the industry.

Legislative proposals have often questioned the need for deducting intangibles from taxable income. Intangibles are the costs of finding petroleum and drilling the wells necessary to produce the oil or gas. They are routine normal costs such as labor, fuel, drilling fluids and bits, and other contracting services.

Gentlemen, these normal expenses are not unlike the nonrecoverable costs of doing business which are deducted by all industries. There should be no limitation whatsoever on what can be invested or reinvested in the business of oil and gas exploration to provide for our Nation's needs.

Most of the currently proposed oil industry tax reforms are directed directly at the small businessman engaged in oil and gas exploration and development. To be specific, so-called limit on tax preferences is applicable only to the individuals, partnerships, trusts, and small corporations. This is a punitive proposal which if it becomes tax law will practically wipe out the independent segment of the industry when the need for our efforts has never been greater.

Not only will the LTP provision wipe out the independents in oil and gas exploration but it could ultimately create a major-company monopoly by destroying all the small businessmen. It does not seem likely that the intent of tax reform is to foster any monopoly, but it will be the inevitable result if there is any limit placed on the amount of drilling that the independents can do.

The basic economic facts of fundamental importance to our industry and the national security have become obscured and confused. It appears that the emotional aspects of tax reform proposals have shaped into a discriminatory program, not to a soundly considered piece of tax legislation.

Instead of creating the necessary economic climate for the expansion required, the proposals you are looking at would destroy most of the incentive for petroleum exploration.

Thank you.

Mr. ENGSTRAND. Next on our panel is Mr. Tom Schwinn, executive vice president of the Kansas Oil & Gas Association.

Mr. SCHWINN. Mr. Chairman, members of the committee, we thank you for the opportunity to appear.

Kansas Independent Oil & Gas Association is one of the largest independent petroleum associations in America. It has no major company members, and it is producer-oriented.

In Kansas the independents play a predominant role in the oil and gas industry. You all know, I think, that historically Kansas has been one of the leading producers of both oil and gas. But I think you might be interested to know that in 1968 independents drilled 96 percent of all the oil wells in Kansas, both development and wildcat. We produced 65 percent of all the oil in the State.

Now, taking that fact into consideration, we submit that it is obvious that in Kansas, and we think also perhaps in most of the great oil producing provinces of the United States, the development of our petroleum resources on shore is going to rest in the hands of the domestic independents.

Now, it is absolutely vital that the tax policies which have fostered and encouraged the development of our Nation's resources be maintained and improved. It is especially important that these incentives, as we term them, be maintained for the independent because of the peculiar way in which independents raise their capital.

Indepedents raise a great deal, may I say most, of their capital from sources outside of the industry, whereas larger, more integrated companies are able to generate at least a certain part of their capital from the sale of products and other matters, and it is going to be impossible in the future, considering the great risks involved, for independents to attract risk capital into this vital industry unless these incentives are maintained and improved.

Of all the incentives currently available to us, the privilege of expensing intangibles is the one most important. I would like to term it the sine qua non of the independent oil business, because no businessman will take the awful risk to look for oil and gas unless he has the privilege of deducting out in that year his cost of participation.

Depletion, of course, is also very, very important, and it is my judgment that, in Kansas, all the active independent oilmen, the people that are actually out looking on a daily basis for oil and gas, are more than drilling up depletion.

Now, we recently did a study of a great number of independent operators in Kansas, and I intend to furnish members of this committee with the study. It is composed of figures not on a selective basis but total figures, company by company, taken from 1968 tax returns which show that the average independent in Kansas does not realize 27½ percent but realizes 20.4 percent.

The cut suggested by the House would reduce that level to below 15 percent, and, gentlemen, we suggest that that would be disastrous.

Now, as I pointed out, indepedents drill most of the wells in Kansas, 96 percent last year. The percentage is going up. Several of the Senators have questioned the availability of gas supply, and I would like to make one remark that has not been made, but it should be, and that is that most gas is found in connection with the search for oil. This is particularly true in Kansas.

Kansas stands seventh in the production of natural gas, but there is literally no available supply of free gas in Kansas for dwelling heat and industrial development because of the intrusion of the Federal Power Commission into the production of natural gas. All the big reserves in our field are tied up. Nevertheless, we need to continue the search for these small gas fields which cumulatively are very important.

As our reserves of gas and oil have gone down, and we have submitted, I think, a graphic chart which appears on page 198 of the committee print today. We are not only running out of these items, we are running out of oilmen. The University of Kansas used to have a petroleum—a fine petroleum engineering department. They do not even call it a department any more. It is a little cubbyhole with one or two students enrolled, and I think that this is happening in most of the great universities of the Midwest and Southwest.

Now, we have done a particular study on the limited tax preference proposal by the Treasury Department. I would very quickly like to go over those. Although not mentioning the proposals formally, quite a number of Treasury officials have talked about the inclusion of capitalization of intangibles. This would be disastrous.

Depletion again is very important. The effect of LTP proposals, though, if you mention sound assumptions, would be most adverse upon the young oil operator or the new small investor in the business. It would not be so harsh on perhaps other classes.

We think the recapture rule that is suggested in the LTP would be very adverse, because it would not only deny the privilege that independents now have of selling a lease to pay off a bank, but it would require the maintenance of records over years and years, the result being maddening.

There has been some talk today about losses that the industry might incur or do incur and thereby affect their tax position, but the petroleum industry is a great deal different than most other kinds of industries.

There are offset obligations, there are farm-out commitments, there are production problems that occur in the last quarter of the year. There are very expensive problems in deep holes, any of which can occur at any time and do, to completely revise a well-planned, prudent program.

Therefore, we say that the Treasury proposal with respect to tax preferences should be turned down. In our State we pay over $20 million in ad valorem taxes. This goes to a great extent to support the schools and local governments. Many of our counties, and of the 105 we have got 90 that produce oil and gas, over 50 percent of their total revenue in the counties support schools and local government, is paid by the oil and gas industry, most of which as I say are independents.

We have attached at the very rear a study that was done by the Kansas Geological Survey in conjunction with the economics department of the Kansas State University which graphically shows the contribution that the petroleum industry makes, the producing petroleum industry makes, to our State of Kansas, and we submit to you therefore, gentlemen, that both the proposals contained in the House bill and the Treasury Department proposals with respect to our industry be rejected.

I thank you very much.

(The committee subsequently received the following statement from Senator Pearson relative to the preceding testimony:)

Statement of Hon. James B. Pearson, a U.S. Senator From the State of Kansas

Mr. Chairman, I have read and studied the testimony presented by Mr. Tom Schw[illegible] and Mr. Richard Hoover representing the Kansas Independent Oil and Gas Association, (KIOGA). I think theirs is an excellent statement and an effective analysis of the very adverse impact that HR 13270 would have on the Kansas independent oil and gas industry and the state economy as a whole. I want to endorse KIOGA's statement. I believe it is a real contribution to the record of these hearings. I know that the members of this committee and the staff will give it careful consideration.

Because of this excellent statement by the KIOGA representatives I will not make detailed comments about the specifics of those provisions of HR 13270 pertaining to oil and gas. However, I do want to make some general observations.

There are many myths which surround the oil industry in this country. There is the popular image of the oil man as a cigar-chewing, Cadillac-driving fat cat whose money comes not from oil wells but from tax loopholes.

These myths and popular images are especially far removed from reality insofar as the independent oil producer is concerned. I am keenly aware of this discrepancy because in Kansas, which ranks seventh among all the states in crude oil production, the oil industry is made up primarily of relatively small, independent operations. The typical Kansas independent producer is a hard working businessman engaged in high risk oil and gas exploration. It is the independent who is carrying on the tough and speculative business of finding and developing new oil reserves.

From my own observations and study of the Kansas oil industry I am convinced that the depletion allowance continues to be used as originally intended, an incentive for new exploration. I am also convinced that the present practice of expensing non-recoverable business expenses (intangibles) is essential to economic viability of the independent domestic oil industry. This practice is vital to the independent's financing procedures.

In a very real sense the incentives to oil and gas exploration and development are more important today in Kansas than in the past. The principal and more obvious pools have already been identified and the development of new reserves is increasingly more difficult and more expensive.

Crude oil and natural gas reserves in Kansas are declining at a dramatic rate. The number of operators is declining and fewer wells are being drilled.

These trends have disturbing implications for the nation and particularly for the economy of the State of Kansas. About 13 percent of the total economic output in Kansas is based directly or indirectly on oil and gas production. Thus it is obvious that any substantial decline in this vital sector would have adverse ramifications for the entire state economy.

Studies conducted by KIOGA have shown that the enactment of HR 13270 would have the effect of sharply curtailing new exploration and development activity by independent operators in Kansas. As 96 percent of all exploratory and development wells were drilled by independent operators in 1968, it is apparent to me that the oil and gas industry would thus suffer a great deal.

I have couched my statement primarily in terms of the relatively small independent producer because I am most familiar with his problems and concerns. This is not to imply, however, that HR 13270 would not have an adverse effect on the major oil companies as well.

Mr. Chairman, in closing let me just say that I believe the requirements of economic growth in Kansas includes a continuation of the present structure of incentives for oil exploration essentially as it is.

Mr. Engstrand. Next on our panel is William J. Murray, president of the Texas Independent Petroleum & Royalty Owners Association.

Mr. Murray. Mr. Chairman, I came here representing an independent association. I have a prepared statement and a summary which I honestly thought adequately represented their viewpoint and merited your attention, but that was before I realized how much information you have already received.

As I have listened to these other witnesses, the points that I wish to make have been covered. Perhaps I covered them a bit differently. And so if I may, rather than present my prepared summary, might I just confess first of all that, even though I am president of an independent association, I am not a producer of oil or gas or a royalty owner, and my real and honest concern is that of national welfare, of the survival of this Nation.

I would rather than refer to my testimony like the privilege, which may be presumptuous, of endorsing the statement that the distinguished Senator from Wyoming made yesterday relative to the desperate importance of energy to the survival of this Nation.

May I state somewhat of my background. While I come here as a representative of an independent producing association, most of my life I have been employed by Federal and State Governments. I was a teacher of petroleum conservation engineering at the University of Texas. I was a conservation engineer for the Federal Government and for the State of Texas. For many years I was a member and chairman of the State Conservation Regulatory Commission of Texas; I chaired the gas conservation committee.

For 14 years I was chairman of the Petroleum Research Committee. I chaired the Engineering Advisory Council. I was the staff member for the Federal Government for the first study made prior to and at the beginning of World War II of the availability for military needs of oil.

I many years later chaired a confidential study made for the military of the availability of oil for energy in this Nation.

May I state, therefore, that, based on this long experience, I am deeply and dreadfully concerned that the Nation is today not truly aware of the energy crisis that we face, not because of any brilliance but because I so long had to study it and I had available for study records that are not available to many other persons of the overall picture.

Let me acknowledge that those who tell you today that they are not alarmists but that they are concerned about our supply in the future are in my judgment still being overly conservative and that crisis is much closer at hand than has ever been stated.

Therefore, I endorse the statement of the distinguished Senator from Wyoming that we need shale oil. It is distressing that there has not yet been a breakthrough. For 15 years we have been talking about the potential reserves in shale oil, but we do not have them yet.

I am excited and thrilled over the discovery in Alaska. We are going to need every barrel of that. And unfortunately we are going to have to turn to an increasing degree in the future to these admittedly insecure foreign reserves of oil. But so long as it is possible to produce domestic continental reserves of oil and gas, our consumers will be better served and our security will be much less impaired. And so I simply state to you without burdening you with any repetition of the concern of any punitive legislation, tax or otherwise, against the oil industry, that the independent producer is expendable as far as I am concerned, but the results of the independent producers' exploration are vitally needed to this Nation.

One and only one comment about the tax proposals. There has been one proposal, I believe, advanced by Treasury, which I understood was somewhat of a compromise, which would not take away from existing independents earning more than 60 percent of their income from oil those present tax privileges that are necessary for their continued existence in the oil business.

May I simply say as one who is not in the oil business but in hearing Mr. True I do not believe I was in, but I would like that privilege. I would ask that you not consider putting in something that is going to make a closed union like the diamond cutters' union out of the oil industry, and would prohibit from those of us who might like to go in but are not earning 60 percent, not earning anything from oil today, do not close us out, if we some day think we know where to find oil and produce it. Please leave us who are not yet in it the same opportunities.

In summary, I apologize to my association for not speaking for them, but I believe by the other industry spokesmen the role of the independent producer has been adequately covered.

My grave concern is our overstated, overestimated, overoptimistic estimate of our current actual energy supply situation.

Thank you, sir.

Mr. Engstrand. In the interests of time, since my summary is included in my written statement, I think it would be a little redundant for me to summarize all the points that have been covered by this panel.

In addition to this panel we have another speaker and I am going to ask Dave True to introduce him.

Mr. TRUE. Mr. Chairman, I would like to present as the final member of this group Stark Fox, executive vice president, Independent Oil and Gas Producers of California.

Mr. FOX. Thank you, Dave.

Mr. Chairman, as Mr. True has mentioned, my name is Stark Fox. I am executive vice president of the Independent Oil and Gas Producers of California, which is a consolidation of two independent oil and gas producer associations, both of which date back to the early 1930's.

At the outset we join in the statement of the Independent Petroleum Association of America and with the other statements that have been made here today, and will therefore confine our remarks to a description of conditions among California independents and the impact the proposed tax changes will have upon them.

We are opposed to all changes. Their sum total effect is to lessen the oil industry incentives to find and develop the more than 80 billion barrels of oil needed between now and 1980. The Congress and the administration should be considering ways to add to those incentives rather than reducing them.

In my prepared statement there are statistics which I will not read, but which I assure you support this statement. Conditions in the California oil industry, particularly for the independent, have seriously deteriorated during the past 10 to 12 years. In spite of the obvious deterioration in the independent's position, and in spite of the fact that district 5 does not produce enough oil to fill its own needs, there are those who would further dampen the incentives to explore for and produce oil. They are the ones who would eliminate, reduce or otherwise adjust the depletion provisions in the Internal Revenue Code as well as change other industry tax provisions.

Up to this point they have not succeeded in doing so.

According to press reports, the so-called tax reform bill passed by the House, coupled with the recommendations of the Treasury Department, would burden the oil industry with additional annual Federal taxes of some $600 million. We do not pretend that the ratio of oil production to taxes is direct.

However, using that ratio as a rough guide, the district 5 producing industry's share of that added annual tax load would approximate $84 million per year; based upon its current 14-percent share of national production. We make no effort to determine how much of the added tax burden would fall upon independent and principal minor companies. It would be a significant sum, however, because together they account for 47 percent of all California production and, whatever the amount, it would come directly out of their pockets.

Governor Bartlett stole some of my thunder. I am glad he did. He supports me in saying they cannot pass it on—that is, the independent cannot pass it on—pass on these added costs. They are not integrated companies. They cannot offset a tax increase by charging the ultimate consumer higher prices for their product. They have no ultimate consumer in the classical sense.

It is common knowledge that in the oil-producing industry the buyer and not the seller determines the price that will be paid for crude oil. Hence the producer has no way of shifting the burden of any added expense, be it taxes, higher wages, or any other.

The impact of such added expense is particularly severe for the California producer. California is the only oil-producing region in the Nation where average crude prices today are less than they were in 1959, 10 years ago. They are 4 cents per barrel less than they were then. This is disincentive enough for the California producer, but the tax reform bill passed by the House and Treasury Department recommendations would further curtail his ability to maintain his present none too enviable position.

And why did all this come about? Because of pressures, Treasury Secretary Kennedy is reported as saying. The chairman of the House Committee on Ways and Means was quoted to a similar effect during that committee's deliberations on the bill.

It seems to us that in saying that the recommended changes in Federal oil tax policy, and particularly in the depletion provision, in saying that these changes were brought about by pressures, those who sponsored them or acquiesce in them tacitly admit that no thought has been given to the merits of the case.

The Wall Street Journal supports that opinion. In speaking of the House action on the bill before you, it had this to say, and I quote:

> Everyone is in favor of reform and after more than four decades it is likely that oil taxes could use some of it. Both the Nation and the industry would benefit though from one thoughtful study of the change in its possible impact. But no—

And I am continuing to quote—

> but no, here as elsewhere the tax reformers have simply slashed away and the House has pushed through the whole package without bothering to give it more than a passing glance.

We have tried to give you some idea of the impact of the proposed changes upon the California producer. Our petition to you is simple. We reiterate our opposition to all the proposals and ask only that before you judge because of pressures rather than merits an oil tax policy that has served this Nation for some 43 years you make one thoughtful study of the change and its possible impacts.

Thank you.

The CHAIRMAN. Thank you very much, gentlemen.

Senator HANSEN. Mr. Chairman, may I ask one question?

First, let me acknowledge with my real appreciation the very generous remarks you made, Mr. Murray.

You have testified that the LTP, the limit on tax preferences, will have a very serious impact upon the independents. I would like to ask the panel, and whoever wishes to respond may, will the Treasury proposal, the 60-percent rule, eliminate the independents from the impact that this LTP may have upon the oil industry?

Mr. TRUE. Senator, if I may attempt to answer that, first, no; because, of course, the 60-percent rule does not include depletion.

Secondly, insofar as intangibles are concerned, I know many independents who have associated work, associated income with the production of oil and gas, who would not be covered by the 60-percent rule because 60 percent of their total does not come from as I believe is quoted the sale of oil or gas.

In my own case all of our income except for a few nickels here and there comes from oil-related activities, but because of the experience

I related a little while ago in our exploration program, 60 percent of the total does not come from the sale of oil or gas, and so we will be included, and I know lots of other people such as drilling contractors, pipeline people, oil lease brokers, servicing companies would fall in the same classification.

Senator HANSEN. Mr. Chairman, I have further questions but I do want to congratulate these fine gentlemen on their excellent presentation. I believe that their successful testimony exhibits their keen knowledge in this area.

Mr. MURRAY. May we express to you, Senator, our appreciation for your leadership, knowledge, and ability.

Senator MILLER. Mr. True, I want to thank you for an excellent presentation. For a long time I have been very much opposed to any tampering with the intangible drilling and development costs. I have engaged in a good many debates over the years opposing tampering with the intangible drilling costs. I should like to forget about the rest of the bill and concentrate on percentage depletion. I have also stated publicly that I do not approve the meat-axe approach in cutting back on depletion. But the thrust of your testimony this morning emphasized the need to increase our reserves to meet our requirements in the future. The chart you had before the committee emphasized that we have to meet it, and in effect, I think your testimony was to the effect that if you want us to achieve those national objectives, leave us alone. In addition, Mr. Cleary talked about the apple tree and the necessity of setting aside some seed. If the seed is used for more apple trees and is used to go ahead and develop their drilling and expanding their resources, that is one thing. If not, that is another thing.

I must say that if we have two companies and one company has $100,000 of percentage depletion seed money and uses that seed money and another company has that seed money and doesn't use it, then there should be some difference in treatment.

What the House has done is they have said to both of these companies, each with $100,000 of percentage depletion, treat them both the same—and this troubles me very much.

Mr. MURRAY. Mr. Chairman, I would like to present another philosophy of the depletion allowance which we refer to as an incentive, the jackpot. The slot machine at Las Vegas is there as an incentive. The game is played by gamblers although they know the odds are against them but because the jackpot is there they are willing to play. If you happen to hit the jackpot, you can keep it, but although they usually put it back in. I think they do plow it back and want to plow it back. However, if you told them they had to plow it back, and there was a sign on the machine saying, "anyone who hits the jackpot must put it back in the slot machine then you destroy the incentive when you tell them so. The plowback destroys much of the illusions of the incentive.

Senator MILLER. I think you have a point, but I don't think your example quite fits. Testimony says we are going to plow it back in. A slot machine operator doesn't go and say no matter what happens, I will plow it back in. With respect to your point about the disincentive this gets you down to what might be done in giving some relative—or attaching some relative—importance to plow back. One approach could be to say, "we take the House-passed percentage depletion rates, but if there is plow back, then we will keep the old rates. That would be one example so that there is still some incentive but if you want to keep your old rates of 27½ percent, then you have to have plow backs. You can keep the extra 7½ percent that you still plow back. Have a 2-year plow back, that would mean that one-fifth of your percentage depletion had not been plowed back. One fifth of the 7½ percent extra would not be allowed. This is a much more refined approach. It fits with your testimony. That is what I am trying to come up with. If you have $100,000 depletion and he plows it all back in, I can't see why you should be treated identically, if you want to take the 20-percent depletion. If you want 27½ percent, plow it back; if you don't want it, then plow half of it back. Now I'd like to discuss percentage depletion because I am opposed to monkeying with intangibles.

Forget about the rest of the provisions in the bill. I would guess that a great many members of the committee opposed—put percentage depletion in perspective. I think they are advocating a meat-axe approach. I can't see treating the two examples identically. Try using your analogy of the seed money. I think that there is a strong feeling on the part of many people that there is some abuse in the petroleum industry. Most people who complain about it don't know beans about it. I know some people who are fairly familiar with the subject, and they think there are some abuses and should be some differences in treatment. I am trying to satisfy that feeling so that you can see we are not treating everyone alike in the petroleum industry. Consumers of this country are treated a little better.

Mr. HINTON. A pipeline producer that produces a portion of its own natural gas has been required to pass on its own depletion to consumers who have obtained the benefit of that depletion. The pipeline producers have gone out of business because of the result of the removal of the incentive.

Senator MILLER. I think we received testimony earlier today that if the 27½ percent depletion rate were cut to 20 percent, it would reduce exploration and development by 20 percent. I suggest to you most respectively that if this were reduced from 27½ to 20 percent for those who do use the seed money and kept it at 27½ percent for those who don't drill up their percentage depletion the results you mention are not in the ball park.

Mr. HINTON. If the pipeline producers of natural gas had the option to utilize that money to drill instead of it being passed on, then they would continue to drill.

Senator MILLER. If they had had the plowback alternative, they would still be in business.

Mr. SCHWINN. Of course, some companies would be making studies for possible lease blocks or exploratory work but they would be harshly penalized if they lost their depletion during this period.

Senator MILLER. This is why I have suggested the 2-year period for plowback. I don't know what is wrong with the 2-year plowback. It would meet none of those problems you mention.

Mr. MARTIN. I am sorry to be so presumptuous. I just want to raise a couple of questions. First, in the area of application of the depletion—it varies from 27½ percent down to zero and is computed on a property-by-property basis. Second, since it was pointed out in the testimony that investors from outside of the industry participate in drilling ventures would people in these categories have the same treatment?

Senator MILLER. The doctor who would like to get into a venture—if he gets the check at the end of the year, he is very happy. When he gets a big check at the end of the year, he is happy. Before he goes into it $2,500 of which $2,500 is percentage depletion if you don't want to pay tax on it, that might be a disincentive. On the other hand, it could be an incentive for him to go into another venture. Let him say that 20 percent is percentage depletion. You have the incentive, but you recognize the principle I am striving for. Using the seed money.

Mr. FOX. It is perfectly true under the conditions you have set forth that one company might take his $100,000 worth of depletion allowance and not use that allowance to explore for future oil supplies; but on the other hand, the present 27½ percent depletion allowance not reduced at all does not generate enough capital that the industry, as an industry needs to have. The entire industry retains, through the depletion allowance, something like $1½ billion. And then its entire exploration expenditures are something like $4 billion.

Mr. MURRAY. The point is that other industry people spend more money than they receive from depletion trying to explore and develop new supplies. Your suggestion certainly would not reduce the retention of funds as much as the House meat-axe approach would do, but it would do so to some extent.

Senator MILLER. I would expect a relatively minor effect, but there are some abuses involved. Unsophisticated constituents. But if I get a question, "Are you going to treat one the same as the other?" Then, I can look them in the eye and say there should be some incentive.

Keep the new House rates, but if you want the old House rates——

Mr. MURRAY. We are not in a position to say that we don't think that everything that now exists is not only deserved but needed—90-year old man do the best you can. If we were given 20 percent plus 7½ percent more if it is plowed back in, we say that is much better than 20 percent across the board. We must face reality. However, the full 27½ percent and more is much needed. We realize the need for the producer to provide a justifiable position. We think that what we have and more is necessary.

Senator MILLER. Let me say that I have no clients, there is no oil industry in my State. I had become interested when—and knew something about it because I have been opposed to a meat-ax approach. I have been questioned on my position, and it is too bad but they don't know what they are talking about. At the same time, I must tell you that a great many people have a feeling that there is something here that ought to be changed. Are we going to change it by a meat-ax approach or by a way which will enable us to say we are not treating everyone alike to fit with our national objectives. I think if we could do something like this it would be good for everyone.

Mr. HINTON. What would happen, then, to the funds that would be raised for drilling from the outside investor. Would he then get his depletion for 27½ percent on the first year and then if he didn't plow it back in, he would be cut back to 20 percent.

Senator MILLER. I think we are getting down to mechanics. For example, let's take the doctor. He puts in $2,000 in the venture and the venture is successful. If not, he writes it off. In comes a check for $2,500 of which $500 is percentage depletion and you don't have to pay tax on it. Now, he has 2 years from that year to take that $500 and go into another venture. The following year in comes another check for $500. If he doesn't put it back in, then he will have to pay a tax. He will have one-fifth less than the 7½ percentage difference; $500 percentage depletion. Computed at the rate he pays $2,000 on the regular income. $500 is percentage depletion at 27½ percent. If he doesn't plow it back in, then under the suggested approach, he would have a portion of that reduction (reduced), would only be allowed 20 percent for depletion.

Mr. FOX. Ultimately, this original $2,500 income that he gets from his $2,000 investment, $500 is nontaxable because of depletion. That is a single venture, and it is completed. It is whole. Because he invested his money in exploration and because it was successful, he gets 27½ percent. What happens if he does not reinvest his depletion in future years?

Senator MILLER. He would continue to receive the House rate. He would have 27½ percentage depletion for 2 years, but if at the end of that 2-year period he has not plowed it back in, then he is going to have to pay tax on $100 because 20 percent is the basic rate.

Mr. MCKEITHAN. Under this concept, most of the independents get 20 percent or less than that because of the 50-percent net limitation, so in order to raise these funds, do you think the 50-percent limitation could be increased to make more money available for drilling?

Senator MILLER. I want to concentrate on the 27½-percent depletion rate. It may be that there are some other facets to this. On that point, I don't know what the Treasury estimates will be.

Mr. MCKEITHAN. We always have to deal with our landowners. Under this method they would be getting 20 percent depletion and if those of us who drill had the 50-percent limitation raised, we might approximate the 27½ percent and thus the landowner would start asking more from us in the way of bonuses, and so forth, for the right to lease his land.

Senator MILLER. I would suggest that it might be rather minimal.

Mr. SCHWINN. What about a one-time investor who invests because he had a windfall. He had excess capital at the time he would like to invest.

Senator MILLER. He would have to live with the 20 percent because he is not carrying out the seed rule.

Mr. SCHWINN. Suppose he invests a small amount regularly because of sales in assets or settlements.

Senator MILLER. I don't want final judgments. You people are the experts. All of us have been concerned about our national objectives. We also have a problem with the general taxpayer. That is what this tax reform bill is all about. A response to what some people term as a taxpayers' revolt. To the extent we can satisfy both, I think we will be a lot better off. The implication has been made that perhaps there should be a 30-percent depletion. I suppose you could make an argument for that.

Mr. TRUE. I think this is a matter of degree. Where is the return of capital concept of the original discovery value depletion concept in your overall plowback suggestion or are you just considering the taxpayer revolt?

Senator MILLER. Are you talking about permitting of the cost depletion first?

Mr. TRUE. No, the original depletion concept was based on discovery value, which was an assigned capital value to the discovery. Based entirely on the concept that it was a recovery of capital and that capital should not be taxed. Are you discounting this principle completely, or are you figuring that reduced percentage depletion takes care of it?

Senator MILLER. I think they could have set it up at 30, 25 percent, could have set it up at any figure. But the big hue and cry is that someone—expenditure in $5,000 for an oil property and after maybe 3 years, he has this go on forever. The reason it goes on forever is for the incentive to plant the seed. You can make an argument that it is sort of a reward to agree with you that it is a matter of degree. We have national objectives to satisfy.

Mr. TRUE. I know several people in my area who have made a lifetime business of accumulating royalties to retire on. They have a modest retirement fixed but inflation is claiming 25 percent.

Senator MILLER. If they are down in a lower income bracket, there are other aspects of the tax reform bill which will help. They will be getting a 5-percent reduction—according to the Treasury approach—and they will have relief. I am concerned about people who are retired especically low- and middle-income areas.

Mr. TRUE. These people are living on a declining dollar income.

Senator MILLER. The difference might not be too bad.

Mr. TRUE. Twenty-seven and one-half percent of their additional income is untaxed.

Senator MILLER. As against 20 percent, under the House bill. Percentages can destroy the real picture. But I think we had better wind this up. If any of you have any ideas on how this might be refined, I think the committee would welcome it. I know I would. Thank you.

(The prepared statements of the previous witnesses follow. Oral testimony of the next witness commences at page 4554.)

STATEMENT OF H. A. TRUE, JR., TRUE OIL CO., CASPER, WYO., ON BEHALF OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

SUMMARY

1. A healthy, expanding domestic industry has provided the assurance of adequate supplies of both oil and natural gas, and this would be the best assurance for the future.
2. The efficiency of the domestic industry has provided petroleum energy (the producer's average price of both oil and natural gas combined) at a cost of less than $1.90 per barrel as compared with over $2.00 per barrel for imported oil.
3. The domestic industry's activities in searching for and developing U.S. petroleum resources have declined to inadequate levels, imperilling the Nation's economic progress and future security. Assurance of adequate oil and gas supplies to meet future requirements requires much more—not less—domestic exploration and drilling.

4. Proposed changes in petroleum tax provisions would decrease substantially the funds available for exploration and drilling, and sharply reduce the incentive to invest capital in this high-risk business.

5. If proposed tax changes were approved, total expenditures for U.S. exploration and development would decline to only $2.4 billion by 1980, compared with a required expenditure of $8.3 billion—a defficiency of $5.9 billion yearly or more than 70 percent.

6. These tax changes would have a devastating effect on independent producers, many if not most of whom would be forced to liquidate their properties and discontinue exploration and drilling. Competition and the multiplicity of effort that has been a key factor in discovery of new reserves would be seriously lessened.

7. The resulting 1980 deficiency in U.S. crude oil production would result in the U.S. being dependent on foreign sources for over 50 percent of the Nation's requirements—an intolerable situation from the standpoint of national security.

8. The search for new reserves of oil and natural gas is interrelated and inseparable. Natural gas is already in short supply and the proposed changes in tax provisions would aggravate and intensify the existing critical situation as to gas supplies.

9. To offset the effect of proposed tax changes and assure adequate supplies of both oil and gas, the alternative would be increased prices that would cost the consuming public in the order of $10 billion yearly by 1980.

10. Governmental decisions as to federal tax provisions and import policies will determine whether the historical position of U.S. self-sufficiency in indispensible petroleum supplies will be preserved; or whether the U.S. will embark on a course knowingly leading to insufficiency and dangerous dependency on foreign sources.

STATEMENT

My name is H. A. True, Jr., and I am an independent producer, operating the True Oil Company, a partnership in Casper, Wyoming. I am a former President of the Independent Petroleum Association of America, and my testimony is presented on behalf of that Association.

The IPAA is composed of some 5,000 members whose business interests are primarily, and in most cases, exclusively, the domestic petroleum producing industry throughout the 32 producing states of this Nation. I appear before your Committee, therefore, to discuss proposed tax changes and their effect on the domestic industry in general, and the independent producer in particular.

Consideration of this matter should be predicated on the following fundamental premises:

(1) Adequate and steadily increasing supplies of both oil and natural gas, from assured sources, are indispensible in meeting the needs of the consuming public, the country's economic progress and the survival of not only the United States but also the Free World.

(2) A healthy, expanding domestic industry has provided the assurance that adequate supplies are available in both peacetime and times of emergency; and must continue to do so in the future.

Existing tax provisions and other sound governmental policies, such as the Mandatory Oil Import Program, have served the public interest well. The domestic industry has supplied sufficient petroleum at relatively low prices to meet consumer peacetime requirements; to fuel two World Wars; to block aggression in several lesser wars; and to prevent wars that might have exploded during such times as the 1956–57 Suez Crisis and the 1967 Middle East dispute.

For the foreseeable future, there is no practical, dependable or economic alternative to an expanding domestic industry. The life of our country could not tolerate the denial of petroleum energy any more than the lives of our citizens could survive the denial of food.

Trends in recent years, unfortunately, imperil the Nation's strength as to oil and gas supplies. These changing conditions are set forth in the memorandum attached to my testimony. These facts must be taken into account in considering petroleum tax provisions. They show that the industry's activities in searching for and developing the petroleum resources of the Unitied States have declined to inadequate levels.

These trends are reason for concern, but not pessimism. They can and must be reversed in order to assure adequate U.S. petroleum supplies. A healthy economic climate, in which adequate incentives exist for vigorous and expanding petroleum exploration and development, can and must be restored. During the past two years, there has been some upturn in the industry and, under sound governmental policies, domestic producers can and will continue to supply the oil and gas requirements of this Nation.

However, we are now at the cross roads. The Congress is con ring major changes of the industry's tax treatment and the Executive Br n of government is currently making an extensive study of the Mandatory Oil Import Program. Decisions with respect to both of these matters will determine, to a very large degree, whether our nation will continue to be self-sufficient in petroleum. Or whether, for the first time in our history, we will knowingly embark on a course leading to a position of insufficiency and greater dependency on foreign sources.

Proposed Tax Changes

Petroleum tax provisions should be looked upon first as a resource policy and secondarily as a tax issue. We have, therefore, made an evaluation of the long-range impacts of proposed changes in tax policy on the development of domestic petroleum resources, in the hope that such an analysis will be helpful to your deliberations.

Certain tax proposals (such as extension of the surtax, repeal of the investment tax credit, and the change in the treatment of capital gains) would adversely affect all businesses, including the petroleum industry. Additional proposed changes in federal tax provisions directly affecting U.S. oil and gas supplies include:

(1) The changes incorporated in the "Tax Reform Act of 1969," as passed by the House: the reduction in percentage depletion from 27½ to 20 percent which would reduce substantially the funds and incentives for the entire industry; the treatment of production payments as loans which would have the practical effect of eliminating the use of this method of financing for independent producers; and the allocation of deductions which could make percentage depletion and intangible drilling cost deductions less effective for individuals.

(2) The additional changes recommended to your Committee by the Treasury Department: the further reduction in percentage depletion for individual operators by inclusion of depletion as a "tax preference"; the limitation on expensing of intangible, or non-recoverable, expenditures by inclusion as a "tax preference" for individual operators that obtain less than 60 percent of gross income from "the sale of oil and gas"; and the taxation as ordinary income, under a "recapture rule," on the sale of oil or gas properties to the extent of intangible drilling costs previously deducted. Individual, independent producers would bear the primary and damaging burden of these changes.

The above tax changes would substantially decrease the funds actually available for domestic exploration and development. In addition, and perhaps of equal or greater significance, these tax changes unquestionably would have the psychological effect of further substantial reductions in the incentive to invest capital in the high-risk business of oil and gas exploration. I am convinced that the mere consideration of these changes has already had the psychological effect of discouraging investments. In my own case, their adoption would put me out of the business of exploration and development.

Including depletion and/or intangible expenses in any "Limitation on Tax Preferences" (LTP) would have a crippling impact on the operations of independent producers. For example, we made a study of the effects of the Treasury Department's LTP proposals to the House Ways and Means Committee, covering the operations of 56 independent producers. This study revealed that the proposed tax change would have had the effect of reducing the drilling expenditures of these producers by 75 percent. The resulting loss in oil and gas supplies would far outweigh any temporary gains in tax revenues.

The LTP proposal, the allocation of deductions, or any other form of the minimum tax concept, should not treat "Intangible Drilling Costs" (IDC) as a "preference." Intangible drilling costs are ordinary business expenses, paid in cash by the oil producer. The current expensing of IDC, does not permit a taxpayer to conclude the year with untaxed funds on hand. To the contrary, it merely permits the taxpayer to make a deduction for money actually spent—not income. It is entirely inappropriate, therefore, to include this item in any type of minimum tax proposal.

Likewise, with respect to depletion, it is submitted that it is also inappropriate for this item to be included in the LTP proposal or any other minimum tax proposal. Percentage depletion cannot exceed 50 percent of net income from any property. The present law, therefore, already has embedded within it the minimum tax concept.

In addition to the tax changes approved by the House and recommended to your Committee by the Treasury Department, there are other proposals which are of great concern to the domestic petroleum industry. These include a graduated scale for depletion based on the amount of gross income; a limitation on depletion based on the amount "plowed-back" into exploration and development; and a requirement that intangible drilling costs be capitalized and written off over a period of years. Each of these proposals would have serious adverse impacts on U.S. oil and gas supplies, and would compound the unhealthy effects of the other proposed changes.

It should be recognized that the changes in tax provisions affecting U.S. oil and gas production, now being considered by your Committee, are in conflict with the recently-announced national security position of the Department of Defense that "U.S. domestic petroleum capability *must be available* to meet military needs in case normal foreign sources are denied." (underscoring added)

They are in conflict with the statements by the Interior Department and the Federal Power Commission that there are already actual shortages of natural gas and a real danger of inadequate U.S. supplies of oil.

They prejudge the findings of a study now in progress by a special Cabinet Task Force which has not yet determined our security needs as to oil supplies.

They are in conflict with the interests of the consuming public because the inevitable result would be less oil and gas, or higher prices, or both.

They are in conflict with the welfare of thousands of communities in 32 producing states, whose tax revenues and economic structure are dependent on oil and gas production.

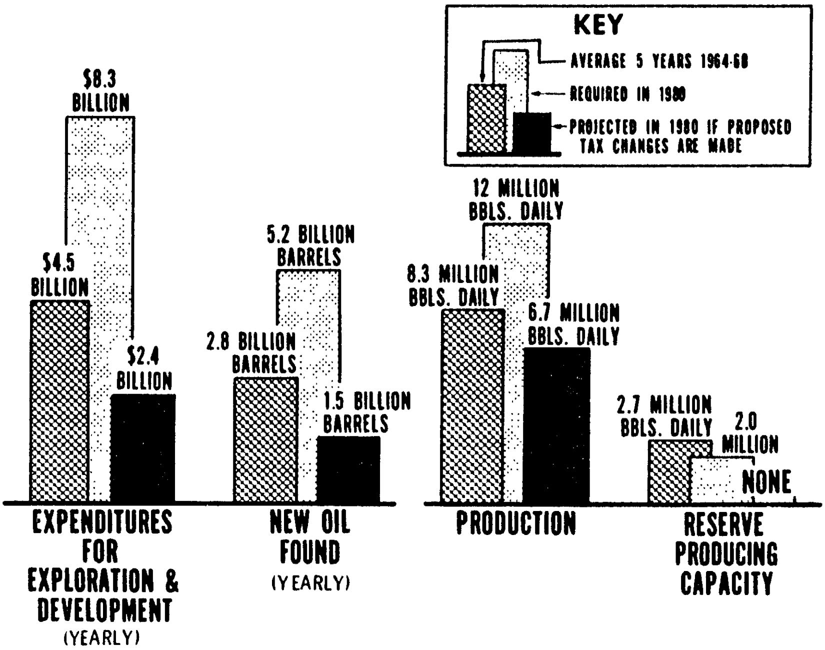
National security, economic progress and the interests of U.S. consumers would be served best by rejecting all proposed adverse changes in oil and gas tax provisions.

Effect of Tax Proposals on Future U.S. Crude Oil Supply

In assessing the effect of the House-approved and Treasury-proposed tax changes on domestic crude oil supplies, we have used the findings of a comprehensive study submitted by the IPAA on July 15, 1969, to the Cabinet Task Force on Oil Import Control. That study showed that total U.S. requirements for petroleum liquids would increase from an average of 12,100,000 barrels daily during the past five years to 18,200,000 barrels per day in 1980, an increase of 50 percent. Imports of foreign oil now supply more than one-fifth of total U.S. oil consumption. To assure adequate domestic supplies, without dangerous increased dependency of foreign sources, the IPAA estimates of oil supplies in 1980 are as follows:

	1980 supply (barrels daily)
U.S. crude oil production	12,000,000
U.S. natural gas liquid production	2,500,000
Imports of crude and products	3,700,000
Total required supply	18,200,000

U. S. CRUDE OIL SUPPLY



This analysis shows that, if these tax provisions were changed, expenditures and supplies would be reduced substantially below current levels, and drastically less than required to provide assurance of adequate supplies to meet the needs of the consuming public, economic growth and national security. A few comments on these figures are in order.

First, total expenditures for U.S. exploration and development would decline by about $2 billion or 47 percent from the level of the past five years. Expenditures in 1980 would total only $2.4 billion, compared with a required expenditure of $8.3 billion; a deficiency of $5.9 billion or more than 70 percent.

Second, and not shown on the table or chart, it is significant to note that, during the latest five year period 1964 through 1968, exploration and development expenditures by independent producers averaged $1.3 billion annually, or about 30 percent of the $4.5 billion expended by the domestic industry. Expenditures by independent producers in 1980 are estimated at less than $500 million, a decrease of 70 percent from the average expenditures during the last five years—a far greater decline than the 47 percent decrease in total industry expenditures. This results from the fact, which should be re-emphasized, that the primary impact of the tax proposals would be on independent producers.

Many, if not most, independent producers would be forced to liquidate their properties and discontinue exploration and development activities. Competition in the domestic producing industry, and the multiplicity of effort that has been a key factor in the discovery of new reserves, would be seriously reduced.

Third, the 1980 deficiency in crude oil production of 5,300,000 barrels daily would have to be imported. Under these conditions, imports would supply about 50 percent of total U.S. oil requirements, with no U.S. reserve producing capacity. This would be an intolerable situation from the standpoint of both national security and the maintenance of peace in the Free World. Russia would be the only major world power in a position of self-sufficiency as to essential petroleum supplies. The United States would have lost its posture of strength in petroleum, and would become subject to the political pressures and demands of producing countries in the Eastern Hemisphere.

In this connection, the September 8, 1969 editorial in The Financial Times of London, England is highly pertinent. That editorial deals with the change in government in Libya and includes the following conclusions:

"The oil has also continued to flow. It is to be hoped that this state of affairs continues. However, the coup has once again demonstrated the fundamental instability and political unreliability of the countries on which Britain and most of the rest of the industrialised world, *apart from the U.S.*, depend for their oil." (italic added)

* * * * * * *

"Security of supply should be given a higher priority than cheapness. In the short run this means that no one country should be allowed to secure a dominant position among Britain's suppliers. In the longer run it may mean that if relatively expensive oil is discovered either in Europe's offshore water or elsewhere—the Canadian Arctic, for instance—is a politically secure country, it should be exploited to our advantage if at all possible, even if it is more expensive than oil from the Middle East and North Africa."

This statement is evidence of the fact that all industrialized foreign countries, including Russia, are directing their policies toward greater assurance of access to essential petroleum supplies. It would be ironic and tragic, indeed, if the United States were to adopt policies that would undermine our capacity to produce crude oil and natural gas.

In discussing petroleum policies, natural gas is too often overlooked. Gas accounts for over 50 percent of the total energy supplied by the domestic petroleum industry. The function of finding oil and natural gas is interrelated and generally inseparable. A reduction in exploration means less oil and less gas.

Unfortunately, unrealistic and short-sighted regulation by the Federal Power Commission has already created a gas shortage. The ratio of proved reserves to production has been declining steadily and substantially. Last year, production outstripped additions to reserves for the first time. Large distributors are already informing customers that supplies are inadequate. Recently, the Federal Power Commission Chairman warned that the nation faces a "critical" supply situation, and the F.P.C.'s "overriding priority" is "to resolve the natural gas supply problem on both a short- and long-term basis."

Adverse tax changes would have only one result: aggravation and intensification of the already critical supply situation as to U.S. supplies of natural gas. In this connection, it should be noted that the domestic producer's price of crude oil and natural gas, converting gas to oil equivalent on a Btu basis, averaged $1.86 per barrel in 1968. This compares with a cost of over $2.00 per barrel for imported oil. The domestic industry, therefore, provides petroleum energy to the American consumer efficiently and at relatively low prices. Aside from the factor of national security—and the term is used in the broadest sense to include economic and political as well as military security—there would be no saving to the U.S. consumer from the importation of foreign petroleum energy.

The consumer would be the ultimate victim of the proposed tax changes. To offset these tax changes and assure adequate domestic supplies of both oil and gas, the alternative would be increased prices. The cost to the consuming public could be in the order of $10 billion yearly by 1980.

Other Effects of Proposed Tax Changes on U.S. Economy

The projected decreases in U.S. expenditures for oil and gas exploration and development and the resulting decreases in U.S. petroleum reserves and production, have far-reaching implications extending throughout the U.S. economy. Some of the more important of these include:

(1) Losses in local and state production taxes

(2) Losses in royalties to Federal and State governments and private landowners

(3) Losses in wages to employees in the domestic producing industry.

(4) Losses in income to manufacturers, suppliers, servicing companies and other allied businesses

(5) Losses in federal income taxes from the above reductions in activity

These losses would aggregate several billion dollars annually. In addition, the increase in imports by 1980 would result in an additional outflow of dollars amounting to over $5 billion annually, thereby seriously aggravating our balance of payments problem.

Conclusions

In conclusion, your Committee is respectfully urged to consider the following:

A. The assurance of adequate U.S. supplies of oil and natural gas requires much more—not less—exploration and drilling by the domestic producing industry.

B. The encouragement and effectiveness of national petroleum policies, particularly federal tax provisions and the Mandatory Oil Import Program, should be improved—not weakened.

C. Under sound national policies, the consumer has enjoyed the benefits of the domestic industry's established record of efficient performance, as evidenced by the fact that the price of U.S. petroleum energy (the average producer's price of crude oil and natural gas combined) is less than the cost of imported oil.

D. Unless prices were increased very substantially, proposed tax changes would result in greatly reduced U.S. oil and gas exploration, development, production, reserves and producing capacity. Resulting dependency on foreign sources would increase to intolerable and dangerous levels, with no reserve domestic capabilities.

E. The independent producer, who has played a vital role in discovering new domestic oil and gas supplies, would become a negligible factor in the U.S. producing industry's operations.

The Nation's posture as to petroleum supplies is at a cross roads. Governmental decisions as to tax provisions and import policies will determine whether the historical position of self-sufficiency will be preserved; or whether we pursue a course leading to insufficiency and dependency on unreliable foreign sources of supply.

MEMORANDUM ON TRENDS IN U.S. PETROLEUM PRODUCING INDUSTRY

(Supplement to statement of H. A. True, Jr., on behalf of the Independent Petroleum Association of America before the Senate Committee on Finance October 1, 1969)

The purpose of this memorandum is to present briefly certain facts, relating to economic conditions in the U.S. petroleum producing industry, that should be considered in reviewing national tax policies as to oil and gas.

Trends in recent years, unfortunately, imperil the Nation's strength as to oil and gas supplies. It is these changing conditions that should be taken into account in considering petroleum tax provisions. The changes in economic conditions are summarized in the form of graphic charts. The charts picture trends in the domestic producing industry since 1956. The industry's activities in searching for and developing the petroleum resources of the United States reached a peak in 1956. The subsequent years have been characterized by:

1. A sharp decline in the search for new U.S. reserves
2. A substantial drop in total drilling activity and employment
3. A steady deterioration in economic conditions affecting domestic producers
4. A weakening of our security posture as to U.S. oil supplies to meet emergencies in the future.

These trends are reason for concern, but not pessimism. They can and must be reversed in order to assure adequate U.S. petroleum supplies. A healthy economic climate, in which adequate incentives will exist for vigorous and expanding petroleum exploration and development, can and must be restored. Under sound governmental policies and favorable economic conditions, domestic producers can and will continue to supply the oil and gas requirements of this Nation.

DECLINING SEARCH FOR U.S. OIL AND GAS RESERVES

The discovery of new reserves, to replace those being consumed, is the foremost and all-important function of the producing industry. Development wells, pipelines, refineries and distribution facilities depend on sufficient new petroleum discoveries to meet increasing requirements.

First Chart

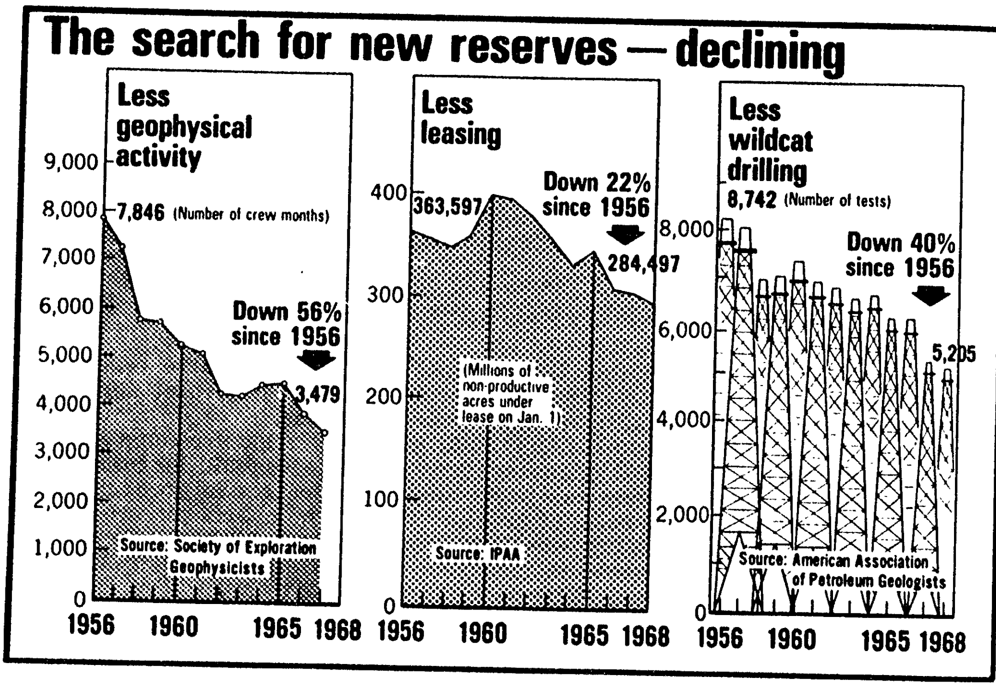
The three sections of the first chart portray essential elements in the search for new reserves: first, the scientific techniques used as guides to possible future producing provinces (as indicated on the chart by the activity of geophysical crews); second, the leasing of acreage not yet productive; and third, the final drilling of wildcat tests, which is the only known method of actually determining whether or not a productive deposit of oil or gas exists.

Obviously, there has been a persistent and sizable decline in all these exploratory activities which has been offset, but only in part, by advances in scientific and technological methods and increased expenditures in such new high-cost provinces as the continental shelf.

Geophysical work, expressed in terms of crew months, has dropped from 7,846 in 1956 to 3,479 in 1967 (the latest year for which data are available). This is a decline of more than 50 percent.

The decrease in advance scientific testing has been followed by a 22 percent decrease in the total non-productive acres under lease in the United States. Almost 80,000,000 fewer acres were under lease in 1968 as compared with 1956.

The effect of declining geophysical activity and reduced leasing are shown in the third section of the chart. The number of wildcat tests drilled in the United States fell from over 8,700 in 1956 to 5,200 in 1968, a drastic reduction of 40 percent.



DECLINING ACTIVITY IN DOMESTIC PRODUCING INDUSTRY

The deteriorating economic conditions responsible for the declining research for new reserves have also been a factor in the shrinkage in the overall activities of the domestic producing industry, as pictured on the next chart.

Second Chart

The total number of active rotary drilling rigs has been more than cut in half—from 2,600 in 1956 to less than 1,200 in 1968. These figures tell only a part of the story. More important than the statistics, equipment has been cannibalized and highly trained employees have left the industry for better opportunities. Today, there is a very critical manpower shortage in the drilling segment of the industry. It is real, and it must be corrected.

The decrease in active rotary rigs has been accompanied by fewer total wells drilled—a drop of more than 25,000 wells, or over 40 percent since 1956.

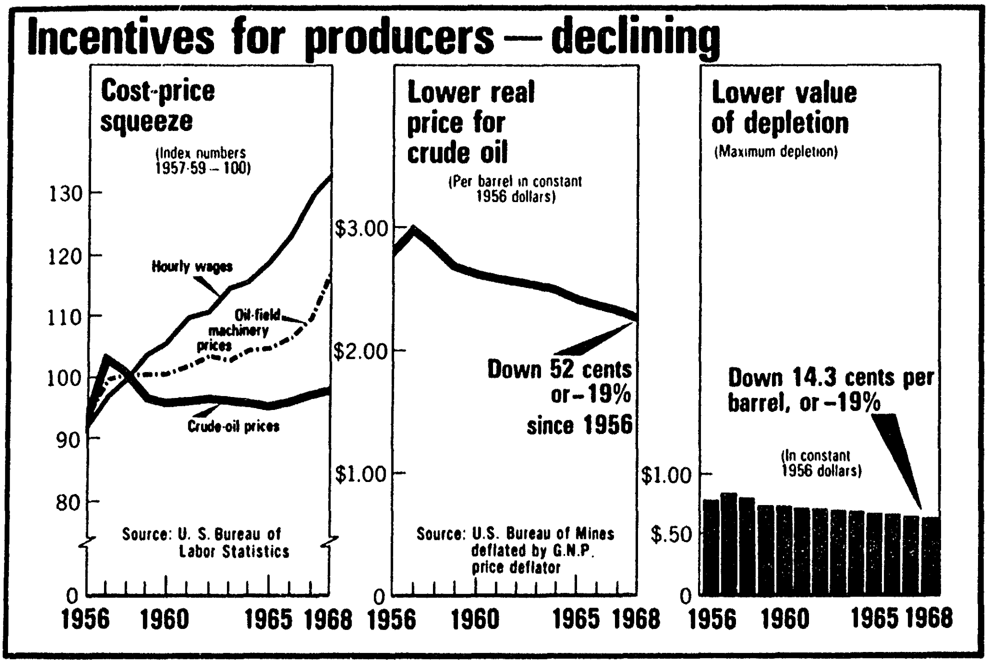
Reference has already been made to the critical manpower shortage in trained employees operating drilling rigs. For the producing industry as a whole, total employment has suffered a decrease of more than 60,000 workers, or almost 20 percent since 1956.

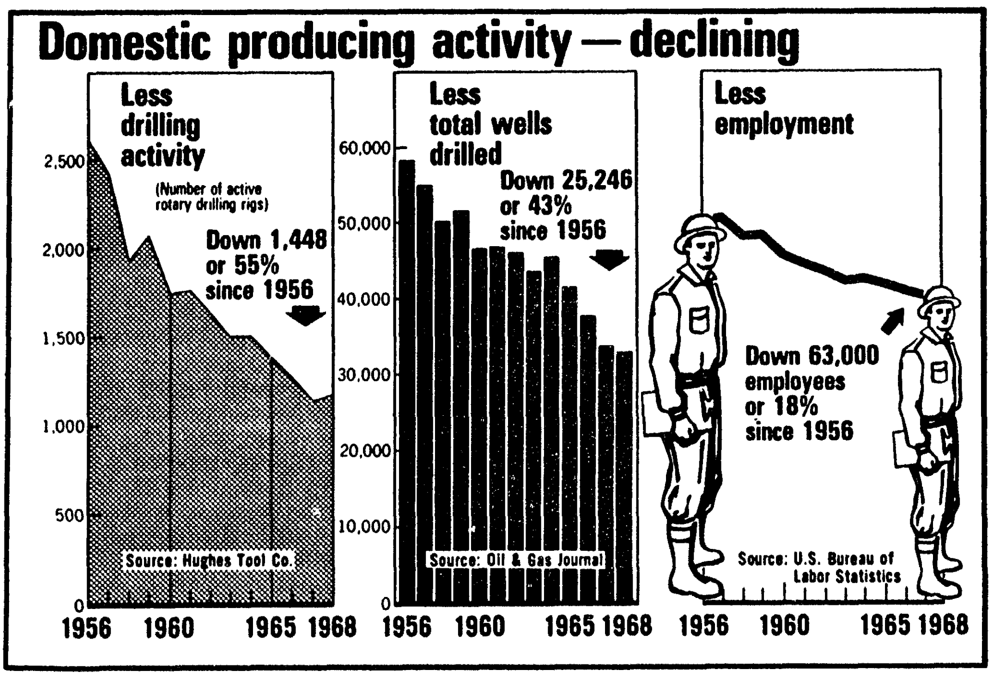
It should be recognized that part of these decreases can be attributed to wider well spacing and increased efficiencies in all phases of drilling and producing operations.

DECLINING INCENTIVES FOR DOMESTIC PRODUCERS

Third Chart

The declining research for U.S. oil and gas reserves and the declining overall activities of the domestic producing industry, set forth in the first two charts, can be attributed to decreasing attractiveness of capital investments in these unusually high-risk ventures. To re-emphasize the degree of risk, only 2 out of every 100 new field wildcats drilled are likely to find large enough to be profitable.





The industry has been caught in a closing vise known as the cost-price squeeze. Since the base period 1957–59, used by the Government in measuring price and cost trends, hourly wages in the industry have increased by more than 30 percent. The cost of oil field machinery has risen by over 15 percent. The average cost of drilling and equipping new wells (not shown on the chart) increased by almost 20 percent in the short period from 1964 to 1967. Inexorably the search for and development of new reserves grows deeper, more difficult and more costly—despite technological advances that have moderated, but not offset these increased costs.

In contrast, the price of crude oil has remained below the 1957–59 level. The average price in 1968 was 2 percent *less* than the 1957–59 price, as compared with the above-mentioned increases in costs and an increase of 8.7 percent in the level of wholesale prices for all commodities.

The result of the cost-price squeeze and the inroads of inflation are demonstrated by the center section of the chart which shows the trend of crude oil prices in constant 1956 dollars. In terms of real purchasing power, the producer has lost 52 cents per barrel since 1956, or almost 20 cents out of every dollar.

The relatively low prices for crude oil have a double-barrel effect. In addition to the cost-price squeeze, the decline in the real price for crude oil results in a lessening in the value and effectiveness of percentage depletion.

Maximum depletion at 27½ percent has declined by 14.3 cents per barrel, or 19 percent, in constant dollars since 1956. Not only, therefore, has the price of crude oil become increasingly inadequate in relation to replacement costs, but also the depletion provision has become correspondingly less adequate as a measure of the capital value of the crude oil being depleted. A miximum percentage depletion rate of 34 percent in 1968 would have been required to prevent the loss in the real value of maximum depletion since 1956. Today, many producers find it more advantageous to sell properties under the capital gains treatment, rather than to continue to operate.

To sum up the situation as to incentives for petroleum exploration and development in the United States, there is an obvious need for more—not less—economic stimuli. A comprehensive study by the National Petroleum Council (the official industry advisory group to the Government, appointed by the Secretary of the Interior) concluded that declining U.S. exploration and development could be attributed to "decreasing profit prospects for new investments."

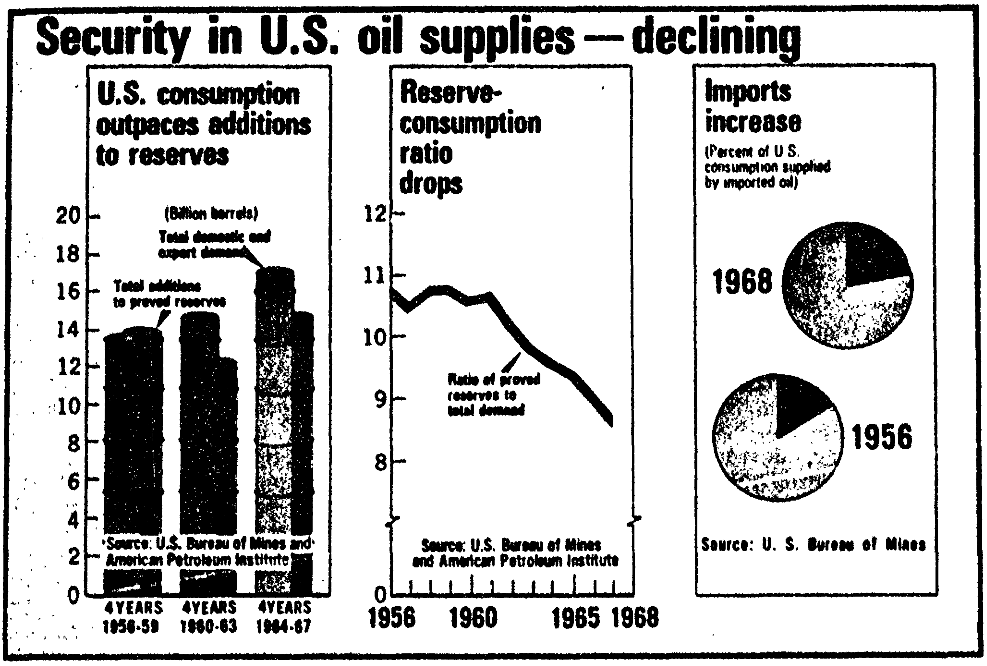
Further declines in economic incentives and further decreases in prospective profitability for new investments would result from any change in petroleum tax provisions. The adverse change that would have the greatest immediate and disruptive effect on drilling, particularly for independent producers, would be any lessening in the effectiveness of the present treatment of intangible drilling expenses.

DECLINING SECURITY IN U.S. OIL SUPPLIES

The foregoing discussion has dealt briefly with deteriorating conditions in the domestic petroleum producing industry. The resulting threat to national security is illustrated by the next and final chart.

Fourth Chart

Total additions to U.S. proved reserves of liquid hydrocarbons have been falling progressively behind our national requirements for petroleum products. In the four-year period 1956–59, additions to reserves were larger than total U.S. consumption. In the latest four year period, total consumption had out-run additions to reserves by almost 2.5 billion barrels. As a result, the ratio of proved reserves to total consumption dropped steadily from 10.8 in 1956 to 8.7. Meanwhile, imports of foreign oil rose from 16 percent of 1956 domestic requirements to 22 percent in 1968.



A statement by the late President John F. Kennedy concluded that, "The depletion allowances which affect over 100 items should be considered primarily as a matter of resources policy and only secondarily as a tax issue." He went on to say that, "Its purpose and its value are first of all to provide a rate of exploration, development and production adequate to our national security and the requirements of our economy . . . The oil depletion allowance has served us well by this test."

More recently, a comprehensive study by the U.S. Department of the Interior entitled "United States Petroleum Through 1980," published in July 1968, concluded:

"Both intangible expensing provisions and percentage depletion have been long standing and durable features of the tax treatment of the petroleum industry, despite repeated efforts to change, reduce or eliminate them. They are an integral part of the petroleum industry's structure of income and expense, and the available evidence suggests that any substantial change in them would have a direct and significant effect upon the future availability and cost of oil and natural gas."

Percentage depletion and related tax provisions have been ingrained for many years in the economic and financial processes of the petroleum industry. Any adverse change in these provisions would have repercussions of vast proportion, including the following:

1. The flight of capital from the industry and disruption of investments, with a chaotic adjustment in industry financial processes.
2. Sellouts and mergers among smaller industry units, already a concern, would be greatly accelerated with a resulting increase in corporate concentration in the production and control of petroleum.
3. Contraction of the industry would result in a reduction in the multiplicity of independent effort that has been so important in the exploration for new reserves.
4. Severe impairment would occur in the economies of the thousands of oil communities throughout 32 producing states.
5. Reduced petroleum activities would be followed by reduced markets for steel, other basic materials, and hundreds of supplying and servicing organizations sustained by petroleum production.
6. Unquestionably there would be less crude oil and gas found and developed in the United States. The alternatives would be either a more concentrated industry at greater cost and much higher prices to consumers, or greater dependence on foreign oil. Neither of these alternatives would be in the interests of the consuming public or, most important, the security of this Nation and the rest of the Free World.

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CONCLUSIONS

Any change in percentage depletion, the treatment of intangible drilling expenses or related federal income tax provisions—designed for the purpose of increasing tax revenues from oil and gas production—would result in less oil and gas and/or higher prices. This fact has been recognized even by academic critics of depletion who have acknowledged that the effect of these tax provisions is to expand investment and output—thus bringing down mineral prices.

Because of the depressing and widespread repercussions of adverse changes in petroleum tax provisions, it is unlikely that such changes would increase federal tax revenues in the long run. The public interest would not be served by weakening the Nation's posture as to petroleum supplies essential to national security, in exchange for the uncertain hope of additional tax dollars.

In conclusion, it should be re-emphasized that the declining trends in the domestic producing industry, as presented in this memorandum, are cause for concern, rather than a lack of confidence in the industry's future abilities. Geologists confirm that there are huge undiscovered deposits of oil and gas in the United States. Advancing research and technology can provide the tools for discovery, development and improved recovery methods. With adequate incentives restored by healthy economic conditions, sufficient domestic petroleum supplies will continue to be available for the consuming public and the security of our country.

TRENDS IN THE U. S. PETROLEUM PRODUCING INDUSTRY
1956-1968

	Geophysical Activity (Crew Months)	Non-Prod. Acreage Under Lease * (Thous.)	New Field Wildcat Wells	Rotary Rigs Active	Total Wells Drilled	Number of Employees
1956	7,846	363,597	8,742	2,618	58,160	340,100
1957	7,242	N. A.	8,014	2,429	55,024	344,000
1958	5,731	347,650	6,950	1,923	50,039	327,500
1959	5,696	358,476	7,031	2,074	51,764	329,500
1960	5,207	364,880	7,320	1,746	46,751	309,200
1961	5,024	362,560	6,909	1,763	46,962	303,100
1962	4,231	351,262	6,794	1,637	46,179	298,000
1963	4,174	333,653	6,570	1,501	43,653	289,500
1964	4,406	315,400	6,632	1,502	45,236	291,100
1965	4,471	332,486	6,182	1,388	41,432	287,100
1966	3,835	295,073	6,158	1,270	37,881	281,800
1967	3,496	292,127	5,271	1,134	33,818	276,800
1968	3,390	284,497	5,205	1,170	32,914	277,500

	Hourly Wages (Index Numbers 1957-59 = 100)	Oil Field Machinery Prices (Index Numbers 1957-59 = 100)	Crude Oil Prices (Index Numbers 1957-59 = 100)	Real Price for Crude Oil (Constant 1956 $) (Per Barrel)	Maximum Value of Depletion Per Bbl. (Constant 1956 $) (Per Barrel)	U. S. Consump. tion (Mil Bbls)	Additions to Reserves (Mil Bbls)	Ratio Reserves to Consump. (Percent)
1956	92.0	93.2	93.0	$2.79	$.767			10.8
1957	96.7	99.6	103.0	2.98	.820			10.5
1958	99.5	100.1	100.3	2.83	.778	13,740	14,185	10.8
1959	103.8	100.2	96.7	2.68	.737			10.8
1960	105.4	100.3	96.0	2.62	.721			10.6
1961	109.7	101.8	96.3	2.60	.715			10.7
1962	110.8	103.2	96.7	2.58	.710	14,975	12.410	10.2
1963	114.4	102.6	96.3	2.54	.699			9.8
1964	115.5	104.4	96.0	2.49	.685			9.6
1965	118.7	104.7	95.3	2.42	.666			9.4
1966	123.0	106.1	96.0	2.38	.655	17,215	14,900	9.0
1967	129.6	109.8	97.3	2.34	.644			8.7
1968	132.4	116.5	98.0	2.27	.624	4,873	3,140	8.1

* Excludes Alaska for which comparable figures are not available for the entire period. Acreage under lease in Alaska declined from 34,265,000 acres on Jan. 1, 1960 to 10,675,000 acres on Jan. 1, 1968, a decrease of 69 percent.

SOURCES OF DATA:

Geophysical Activity from Society of Exploration Geophysicists. Acreage under lease on Jan. 1 from IPAA. New Fi ld Wildcats drilled from American Association of Petroleum Geologists. Rotary rigs active from Hughes Tool Co. Total Wells Drilled from Oil & Gas Journal and American Association of Petroleum Geologists. Number of employees, hourly wages and Oil Field Machinery Prices from U. S. Bureau of Labor Statistics. Crude Oil Price Index based on U. S. Bureau of Mines data. Real Price of crude oil and Value of Depletion calculated by IPAA. U. S. consumption from U. S. Bureau of Mines. Additions to reserves from API. Ratio reserves to consumption calculated by IPAA.

STATEMENT ON U.S. OIL TAX POLICY, SUBMITTED BY CLINTON ENGSTRAND, CHAIRMAN, LIAISON COMMITTEE OF COOPERATING OIL & GAS ASSOCIATIONS

SUMMARY

The Liaison Committee of Cooperating Oil & Gas Associations contends that in order to accomplish the drilling job required by the nation we must at least have—in addition to adequate crude prices and opportunity to produce—the following provisions in our nation's oil tax policy:

1. *Expressing of non-recoverable drilling costs.*—This current tax provision is universally cited by domestic producers as the most important existing tax incentive to encourage exploratory drilling. Even the present low rate of drilling would drop precipitously, should independents be required to capitalize such costs or include such costs in computing income tax liability.

2. *The "loss carry forward" tax provision.*—This current provision is vital in the extremely high risk oil exploration business. Drilling costs approximate an average of $50,000 per well. This cost burden becomes significant in exploratory drilling since only one well in nine finds oil and only one well in each 33 drilled results in a commercial discovery.

3. *Liberalization of the 50 percent net income limitation on percentage depletion application.*—Only by this positive change can the percentage depletion provision more effectively assist in the desired result of increasing domestic oil and gas drilling to levels needed. Without such adjustment domestic independent wildcatters cannot receive the maximum tax incentive authorized under the depletion provision. Even more damaging to the independent would be the Administration's new proposal requiring non-incorporated individuals to include income derived from percentage depletion application in computation of income tax liability.

4. *Retention of capital gains tax treatment for total value of oil and gas property sales.*—Independents must maintain at least the current economic incentive to sell discovered petroleum so that they can be in position to conduct expensive exploration activities. Otherwise, further reduction in already inadequate drilling effort will result causing further reduction in secure domestic reserves.

5. *A positive tax incentive program applied directly to domestic exploration efforts.*—Recognized even by authors of the percentage depletion study submitted by the Treasury Department to this Committee is the increasing need for further attention to the problem of strengthening economic incentive to search for domestic oil reserves. It is in the best interest of the consuming public and the nation's security, as well as the domestic oil producing industry, to seek the most plausible means for achieving this objective. Governmental oil policies can play an important role in this effort.

STATEMENT

Mr. Chairman and Members of the Committee, my name is Clint Engstrand. I am authorized to appear here as Chairman of the Liaison Committee of Cooperating Oil and Gas Associations, an organization consisting of representatives from 21 independent producer, royalty owner and service associations located throughout the nation. Our groups range geographically from Alaska to the Gulf Coast and from California to Pennsylvania.

The producers we represent operate almost exclusively in the inland areas of the United States and concentrate their activity in the exploration, development and production segment of the domestic oil industry. Consequently, we seek national tax policy that encourages rather than discourages development of domestic oil reserves.

To emphasize this position, the Liaison Committee unanimously adopted the following resolution at its meeting in Wichita, Kansas, on September 8th:

"Be it resolved that Liaison endorse any tax legislation (1) which recognizes the dangerous pending energy gap in this nation and the very significant role of the domestic independent in providing for national security and consumer welfare; (2) which recognizes the important, disproportionate role of the independent petroleum producer in exploring for and developing the domestic reserves so vital to national welfare; (3) which supports as necessary to domestic development the continued expensing of non-recoverable costs of drilling; and (4) which returns to the maximum extent necessary incentives for domestic exploration and development."

More than 85 percent of the nation's effort to search for home oil reserves is conducted by independent producers. This high risk, security-vital function constitutes the independents' primary role in the U.S. oil and gas industry. Consequently, if the nation's petroleum discovery effort it in trouble, then so is the independent producer.

The serious decline in U.S. oil and gas exploration activity over the past 12 years submitted in evidence before this Committee by other witnesses here today can only mean, then, a serious decline in independent producer activity. It is equally apparent that if the nation desires restoration of exploration activity to adequate levels, then the incentive for the independent to do so must also be adequate, whether it be in terms of higher prices for oil and gas discovered or revision in national petroleum policy.

Despite this inescapable need, however, the tax reform movement, insofar as it relates to the petroleum industry, has concentrated on ways and means to reduce rather than increase the economic incentive of the independent producer. Attention has been focused on tax changes that would impede independent producer decisions to borrow and/or spend the staggering amounts of funds necessary to drill wells.

Independents operate as individuals, small partnerships or in venture combinations. They rarely incorporate, thereby maintaining the freedom required for well drilling decisions—subject of course to veto by their bankers or investor partners. They are, therefore, highly vulnerable to any adjustment in current tax laws that offer them the incentive needed to drill.

A small business operation in the oil and gas producing industry relies heavily, for example, on the right to expense non-recoverable costs of drilling. Without it, there would be no way to afford the expense of developing discovered oil and gas properties for the simple reason that the independent and his banker must be in position to cope with the non-discovery years in his drilling history that inevitably arise between pertoleum discoveries.

The severe ups and downs experienced by small business in this high risk industrial activity also require the incentive aid that comes from other tax features under attack, including domestic percentage depletion, the ABC payment method, carved-out production payments and capital gains sales of mineral properties. Eliminate or reduce any of these long-standing tax features for either the independent producer or those who help finance his ventures and further reduction in the nation's vital petroleum drilling effort is bound to follow.

Several member Associations of Liaison have representatives here today who have all submitted individual testimony for the record on behalf of their individual Associations. In addition, they are prepared to participate in this oral presentation of the case for the independent producer and royalty owner. With the Committee's permission, I shall introduce each of them and call on them to cover specific aspects of tax reform proposals as passed by the House, as presented by Administration officials before this Committee and as currently being considered by members of the Senate. When they have concluded their remarks, I would like to summarize briefly our position.

In summary it appears obvious to us that regardless of the political necessity to review U.S. oil tax policy, constructive measures must be considered to assure the even more important objective of adequate search for domestic oil reserves. Our consultations involving hundreds of domestic independent producers support our contention that in order to accomplish the drilling job required by the nation we must at least have—in addition to adequate crude prices and opportunity to produce—the following provisions in our nation's oil tax policy:

1. *Expensing of non-recoverable drilling costs.*—This current tax provision is universally cited by domestic producers as the most important existing tax incentive to encourage exploratory drilling. Even the present low rate of drilling would drop precipitously, should independents be required to capitalize such costs or include such costs in computing income tax liability.

2. *The "loss carry forward" tax provision.*—This current provision is vital in the extremely high risk oil exploration business. Drilling costs approximate an average of $50,000 per week. This cost burden becomes significant in exploratory drilling since only one well in nine finds oil and only one well in each 33 drilled results in a commercial discovery.

3. *Liberalization of the 50 percent net income limitation on percentage depletion application.*—Only by this positive change can the percentage depletion provision more effectively assist in the desired result of increasing domestic oil and gas drilling to levels needed. Without such adjustment domestic independent wildcatters cannot receive the maximum tax incentive authorized under the

depletion provision. Even more damaging to the independent would be the Administration's new proposal requiring non-incorporated individuals to include income derived from percentage depletion application in computation of income tax liability.

4. *Retention of capital gains tax treatment for total value of oil and gas property sale.*—Independents must maintain at least the current economic incentive to sell discovered petroleum so that they can be in position to conduct expensive exploration activities. Otherwise, further reduction in already inadequate drilling effort will result causing further reduction in secure domestic reserves.

5. *A positive tax incentive program applied directly to domestic exploration efforts.*—Recognized even by authors of the percentage depletion study submitted by the Treasury Department to this Committee is the increasing need for further attention to the problem of strengthening economic incentive to search for domestic oil reserves. It is in the best interest of the consuming public and the nation's security, as well as the domestic oil producing industry, to seek the most plausible means for achieving this objective. Governmental oil policies can play an important role in this effort.

Statement of Independent Oil & Gas Producers of California, Presented by Stark Fox, Executive Vice President

Mr. Chairman and Members of the Committee, my name is Stark Fox. I am executive vice president of Independent Oil and Gas Producers of California, a consolidation of two independent oil and gas producer associations both of which dated back to the early thirties. We are the only statewide association of producers in California.

At the outset, let me say that we join in the statement of the Independent Petroleum Association of America and will, therefore, confine our remarks to a description of conditions among California independents, and the impact the proposed changes in oil tax policy will have upon them.

Let me further say that we are opposed to all the proposed changes. Their sum total effect is to lessen oil industry incentives to find and develop the more than 80 billion barrels of oil needed between now and 1980, according to the Chase Manhattan Bank and the Department of the Interior. The Congress—and the Administration—should be considering ways to add to those incentives, rather than reduce them.

CONDITIONS IN THE CALIFORNIA OIL INDUSTRY

A 10-year record, 1957–1967, of the California oil industry unveils a gloomy picture, particularly for the smaller independent. The reason we use a 10-year period ended 1967 is that complete statistics for the succeeding period are unavailable. We believe that no significant changes in trends occurred during 1968 or thus far in 1969.

Here are some of the facts:

The total number of companies in the state in 1957 was 1465; in 1967 it was 1044, according to the Annual Review of California Oil and Gas Production compiled by the Conservation Committee of California Oil Producers. The net loss in number of companies was 421, a drop of 29%.

Total employment in oil and gas extraction dropped from 26,000 in December, 1957 to 21,800 in December, 1967, the California Department of Industrial Relations reports in its Labor Statistics Bulletin. The Bulletin also reports that average weekly earnings in the same months of the same years were $111.07 and $146.64, respectively. (Currently, they are $173.43).

The State Franchise Tax Board reports that 1039 companies filed Bank and Corporation Franchise (state income) Tax returns for calendar 1957; only 658 did so for 1967.

Of the 1039 filling companies in 1957, 428 reported taxable income, on which they were assessed $8,263,214.00. Of the 658 filing companies in 1967, 330 reported taxable income, on which they were assessed $16,074,343.00. (Production in 1957 was 928,971 B/D; in 1967 it was 948,722 B/D. Thus the state income tax per barrel of oil produced nearly doubled).

CONDITIONS AMONG INDEPENDENT PRODUCERS

The foregoing data apply to the California industry as a whole, but there is one group, the smaller independent producer, who was hardest hit during the period.

Conservation Committee tabulations show the varying patterns within the industry.

Between 1957 and 1967, the major companies increased their share of total California production from 45% to 53%; the 43 principal minor companies slightly, from 28% to 29%; the independents dropped from 9% to 3.7%. These percentages do not include production from unit operations, in which the small companies have little or no interest.

Figures covering oilfield development show the same trends. In 1957, the majors completed 44.6% of all wells; in 1967, they completed 53.8%. Principal minor companies increased their completions from 24.5% to 37.0%; independents dropped from 30.0% to 8.3%. Again, unit operations are excluded.

In 1957, major companies were credited with 45.5% of all wells; this figure had increased to 53.4% by 1967.

Principal minor companies increased their share of all wells from 25.0% in 1957 to 27.4% in 1967; independents dropped from 22.7% to 10.3%.

DISINCENTIVES

In spite of this obvious deterioration in the independent's position, and in spite of the fact that District V (Alaska, Arizona, California, Hawaii, Nevada, Oregon, and Washington) does not produce enough oil to fill its own needs, there are those who would further dampen the incentive to explore for and produce oil. They are the ones who would eliminate, reduce, or otherwise "adjust" the depletion provision in the Internal Revenue Code, as well as change other industry tax provisions. Up to this point they have succeeded in doing so. According to press reports, the so-called Tax Reform Bill passed by the House, coupled with the recommendations of the Treasury Department, would burden the oil industry with additional annual Federal taxes of $600 million.

We do not pretend that the ratio of oil production to taxes is direct; however, using that ratio as a rough guide, the District V producing industry's share of that added annual tax load would approximate $84 million, based upon its current 14% share of total production.

We make no effort to determine how much of the added tax burden would fall upon independent and principal minor companies. It would be a significant sum, however, because together they account for 47% of total California oil production.

And whatever the amount, it would come directly out of their pockets.

PRODUCERS HAVE NO "ULTIMATE CONSUMER"

They cannot pass it on; they are not integrated companies; they cannot offset a tax increase by charging the ultimate consumer higher prices for their product. They have no "ultimate consumer" in the classical sense. It is common knowledge that, in the oil producing industry, the buyer, not the seller, determines the price that will be paid for crude oil. Hence, the producer has no way of shifting the burden of any added expense, be it taxes, higher wages, or any other.

The impact of such added expenses is particularly severe for the California producer. California is the only oil producing region in the nation where average crude prices are less than they were in 1959—10 years ago. According to the current Statistical Release of the Independent Petroleum Association of America, crude oil prices east of the Rockies average $3.17 per barrel today; in 1959 they averaged $2.95 per barrel.

California crude prices, on the other hand, average $2.51 per barrel today, whereas in 1959, the average was $2.55.

Thus, compared with 10 years ago, producers in the rest of the nation have had per barrel price increases totalling 22 cents; California producers have suffered a loss of four cents per barrel.

This is disincentive enough for the California producer, but the "tax reform" bill passed by the House and the Treasury Department's recommendations would further curtail his ability to maintain his present none-too-enviable position.

And why did all this come about?

"PRESSURES"

Because of "pressures," Treasury Secretary Kennedy is reported as saying.

The Chairman of the House Committee on Ways and Means was quoted to a similar effect, during that Committee's deliberations on the bill.

It seems to us that, in saying that the recommended changes in Federal oil tax policy—and particularly in the depletion provision—were brought about by pressures, those who sponsor them (or acquiesce in them) tacitly admit that no thought has been given to the merits of the case.

The Wall Street Journal—no "friend" of the oil industry, as witness its frequent highly critical editorials about the oil import program—supports that opinion.

In speaking of the House action on the so-called Tax Reform Act, it had this to say:

"Everyone is in favor of reform, and after more than four decades it's likely that oil taxes could use some of it. Both the nation and the industry would benefit, though, from one thoughtful study of the change and its possible impact.

"But no. Here, as elsewhere, the tax reformers have simply slashed away, and the House has pushed through the whole package without bothering to give it more than a passing glance."

We have tried to give you some idea of the impact of the proposed changes upon the California producer. Our petition to you is simple. We reiterate our opposition to all the proposals and ask only that, before you junk—because of "pressures", not the merits of the case—an oil tax policy that has served this nation well for some 43 years, you make "one thoughtful study of the change and its possible impact."

Thank you.

STATEMENT OF INDEPENDENT OIL PRODUCERS AND LAND OWNERS ASSOCIATION TRI-STATE, INC. (INDIANA-ILLINOIS-KENTUCKY), BY D. F. MCKEITHAN, JR., PRESIDENT

Mr. Chairman, my name is D. F. McKeithan, Jr., and my home is in Evansville, Indiana. I am an independent oil producer and the President of the Independent Oil Producers and Land Owners Association, Tri-State, Inc., which association I have the privilege to represent today. The membership of IOPLOA consists solely of small independent oil producers and land owners located in the Tri-State area of Illinois, Indiana and Kentucky.

Before proceeding, I wish to go on record on behalf of IOPLOA as supporting fully the other testimony received today from those independent petroleum associations from other parts of our country, which recognize the role of the independent oil man and the necessity to preserve, as well as to stimulate, his continued contribution to the domestic oil and gas industry. Their remarks are in our judgment sound and well stated. I am, however, here today to tell you about Illinois, Indiana and Kentucky because I know that you, and all the members of this committee, are well versed with the intricacies of the domestic oil business; that you are aware of the serious nature of the proposed tax revisions as they would affect oil. But, you may not know, or be aware of the fact that dependent upon your action an entire industry hangs in jeopardy in my home area. Thus, I will confine my remarks to the three-state area of Illinois, Indiana and Kentucky.

The oil industry to which I refer is almost exclusively composed of small independent producers, suppliers, and drillers. They are the same type of independent who has historically found 80% of our domestic reserves. His usual operation is long on guts and short on capital but, nevertheless, he continues to drill and search for oil Normally, his exploration capital is raised from investors outside of the oil business, from men and women who can afford to risk capital on the 1 in 15 chance that oil will be discovered. Ironically, these same investors who provide the funds necessary to the small independent, are now a primary target of this Congress in its effort to revise the present tax structure.

The proposed tax revisions, if adopted, can only affect adversely those individuals and firms now engaged in the oil and gas industry. This consideration alone is not necessarily a valid reason for avoiding a change. However, all the consequences of any tax change must be measured not only in terms of the immediate revenues expected to be realized but, more importantly, in the long range effects to be expected and the overall impact on the economy and security of our nation. In our Tri-State area, a reduced depletion rate will seriously cripple our segment of the domestic oil industry. This would result in the obvious curtailment of employment with the resulting loss in payrolls and taxes as well as a loss in oil production and, consequently, royalties to the land owners and taxes to the counties.

If it can be recognized that a cut in the present depletion schedule would seriously cripple the Tri-State oil industry, then it is even more apparent that a change in the manner of deduction of intangibles will literally, and without exception, destroy the domestic oil business in our area. Because the principle sources of capital funds relied upon by our operators are derived from outside investors, any required capitalization of such funds will shut off completely this flow of money and force our operators out of business.

Over 1500 small businessmen employing approximately 30,000 men and women in our Tri-State area annually contribute about 400 million dollars to the economy, which includes 30 million dollars annually paid to land owners in royalties and over 6 million dollars in taxes to the counties. As noted, the proposed tax change will not merely work a temporary hardship upon these independents, such changes will virtually eliminate them as a contibuting segment of our economy. Our local economy would be unable to compensate for such a loss. More importantly, we maintain that our country cannot afford to lose this segment of its domestic oil industry. Once it is lost, it is doubtful that either the reserves or the skilled technicians could ever be replaced.

In conclusion therefore, I submit that the action of this committee will very definitely determine the future course of the independent oil man in the states of Illinois, Indiana and Kentucky. Unfortunately, the choice is not one of compromise. Our very livelihood depends upon the decisions you will make.

STATEMENT BY TOM L. SCHWINN, B.S., L.L.D., J.D., EXECUTIVE VICE-PRESIDENT AND COUNSEL, ACCOMPANIED BY V. RICHARD HOOVER, PRESIDENT, CARL W. SEBITS, VICE-PRESIDENT, DAVID TRIPP, C.P.A., WAYNE SUNDLING, C.P.A., ON BEHALF OF THE KANSAS INDEPENDENT OIL & GAS ASSOCIATION

SUMMARY

Drilling, reserves, and productive capacity of both oil and gas, are down in Kansas and in the United States.

1. Intangibles must be preserved at all costs.
2. Depletion and other incentives are also vital.
3. The independent segment deserve special consideration because of its unique and perilous position when pitted competitively against the major international companies.
4. Treasury proposals are an indirect attempt to gut the domestic petroleum industry under the guise of tax reform.
5. The domestic industry is vital to the economic well-being of the producing states and the nation.

STATEMENT

Mr. Chairman, Members of the Committee, the Kansas Independent Oil & Gas Association (Kioga), now in the thirty-fourth (34th) year of its existence, is a petroleum trade association comprised of approximately thirteen hundred (1300) members. It has no major company members. It is producer-oriented.

We are grateful for the opportunity of appearing before this distinguished committee today. We are here to underscore the importance of maintaining and improving current provisions of mineral tax law as they relate to oil & gas. We deem these provisions to be vital to the survival of the domestic independent producer. Collaterally, we shall have something to say about adverse proposals, formal or otherwise, that would do grave damage to the petroleum industry and the energy position of the nation.

Whereas, there are many facets to the Kansas petroleum economy, the independent oil and gas producer continues to be one of its mainstays. Historically, both the major companies and the independents explored and developed the obvious and major petroleum provinces of the state and were the harbingers of the development that occurred throughout the great midcontinent area of the United States. Following discovery and development of these obvious and easily identifiable features, the major companies began to withdraw from Kansas. The hard business of finding elusive oil and gas was left to imaginative independent operators. The state remains one of the principal gas and oil producing states in the nation.

In 1968 more than 96% of all exploratory and development wells were drilled by independent operators in the state of Kansas. Their share of total daily oil production now exceeds 65% and is growing annually. Only in the vast reaches of the Hugoton gas field do the major companies play a significant role in the development and production of the state's petroleum resources. Thus, as will be true in all of the great historic oil provinces of this nation, Kansas' present and future depends increasingly upon the independent oil operator.

The Senate Committee on Finance has the hard task and must assume the responsibility for deciding whether or not this nation shall have an important and viable domestic industry. Tax policies, which are the peculiar function of this committee, have a significant role in determining the level at which this industry will participate economically. It should be no mystery to members of this committee that historically, independent oil men raise the capital necessary for exploration from sources outside of the industry. A modest amount is generated internally. Everyone knows that the search for oil & gas is one of the most highly speculative businesses this side of Monte Carlo. Major companies, because of their sprawling and diversified nature, generate their funds internally, through the sale of products and other items. It is for this reason that the privilege of expensing intangibles during the year in which the item is incurred is so vital to independent operators and not necessarily so important to major companies. Corporate structures, being broad-based, could withstand a period in which intangibles must be capitalized and thereafter be re-captured through amortization; yet there is scarcely an independent in the United States who could sustain a period of more than one (1) year during which his investor would have to capitalize the speculative dollars he spends in the risky business of oil finding.

The world of oil has historically been pictured as a single monolithic industry. This is not true. The world of oil is composed of two segments: independent domestic producers and the major international oil companies. This nation must depend in the foreseeable future upon the independent operator to explore and develop the country's petroleum resources. Because of the relative profitability of foreign oil, the major international companies are spending ever-increasing percentages of their exploration dollar in foreign countries.

Crude oil and natural gas reserves are declining at an alarming rate in Kansas. Already, available supplies of natural gas, so essential for dwelling heat and industrial development, are non-existent. These facts are depicted in the attachment to this statement. The reasons for this decline in reserves (and productive capacity) are two-fold. Numbers of independents are dwindling and fewer wells are being drilled. Both of these trends must be reversed if a genuine energy crisis is to be averted.

Tax policy of the federal government is the hand maiden of a healthy domestic petroleum industry. Incorporated in federal tax policies have been a series of tax incentives which are undeniably vital if the industry is to prosper and meet demands made upon it. The thirst requirements of the nation are growing at an astonishing rate. Tax Incentives in descending order of importance are:

1. *The privilege of expensing non-recoverable business expenses, (intangibles)*.—This privilege is of overriding importance.

2. *Percentage depletion*.—Long considered by some to be a loophole, this provision nevertheless permits a return of capital and pays in part for [illegible] many dry holes that all wildcatters encounter. Contrary to much opinion, producers seldom realize the full 27½%. A recent survey by this association in Kansas disclosed that we are realizing an average net effective depletion rate only 20.4%. Included in this result were scattered good leases on which higher depletion rates are realized.

3. *85% net income limitation on percentage depletion*.—This severely limits depleton and should be liberalized. If this were done, not only more exploration would result, but the ends of conservation would be served, as marginal wells would enjoy a longer life.

4. *Loss Carry Forward Tax Provision.*—This is covered in more detail later in this statement. Suffice it to say that even the prodent operator may experience unexpected losses in any particular tax period. If denied the right to carry these losses forward to the next period, his ability to continue his exploratory efforts will be drastically impaired.

5. *Retention of Capital Gains Treatment.*—This is covered at length later in the statement.

H.R. 13270 has already reduced percentage depletion to 20%. This will reduce the average net effective rate in Kansas to below 15%. Complicating our task has been the efforts of the Department of the Treasury to do by indirection what the Department has not succeeded in doing directly. A special KIOGA Task Force on these limited tax preference proposals has just concluded a study of these matters, which is herewith incorporated as a part of this statement:

The independent segment of the oil and gas industry is in real sympathy with the Treasury's efforts to close and eliminate the so-called tax loopholes which have permitted certain taxpayers to use tax avoidance devices to escape income tax liability altogether or to pay only a minimal amount. However, we submit that the methods proposed in both the House bill and by the Treasury to correct this situation, do not justify the drastic changes and penalties imposed upon the majority of legitimate oil and gas operators who are now paying a fair share of the necessary burden of the cost of government.

In properly analyzing Treasury Department proposals relating to the mineral tax section under Limited Tax Preferences, it was deemed appropriate to note other tax changes, formal or informal, that had been suggested elsewhere or incorporated in a bill. Following passage of the House version of the tax reform law, called by some "the most incredibly complicated tax law in U.S. history," containing categories of proposals which overlap to the extent that the result is grotesque, the Treasury Department now has suggested to the Senate Finance Committee a widened series of proposals that add more complexities:

ANALYSIS OF TREASURY LTP PROPOSALS

1. Capitalization of intangibles (non-recoverable business expenses), even on development wells, which was not proposed formally, but was mentioned, would have the most adverse effect upon the domestic independent petroleum industry.

2. The House-passed cut in depletion from 27½% to 20% was found to be next in severity in its adverse impact upon the domestic independent. Studies disclosed that this change would add approximately 15% to the adjusted gross income of the established investor.

3. (a) LTP provisions would have a nominal effect on the established oil operator or high income investor.

(b) For the young operator with minimal oil and gas income, or for the investor, with small outside income, the reverse is true. Using some reliable assumptions, the adjusted gross income of these two classes of taxpayers was increased by 124%. The reason for this is that the young man started in the oil business, either as an operator or as an investor, is spending a greater proportion of his total income on LTP items than is the older, wealthier individual, operator or major oil company. Please note that the latter category of taxpayer, being incorporated, is not subject to the provisions of LTP.

4. We strongly disagree with the inclusion of the intangible drilling cost deduction in the Allocation of Deductions provision. Moreover, we urge that the 60% limitation for the application of ADR be derived from oil and gas *operations*, including, but not limited to, all phases of exploration, development, drilling and producing, as suggested by Secretary Kennedy, rather than from the *sale* of oil and gas as recommended by Mr. Cohen. There are a number of legitimate related activities for fully qualified oil and gas operators.

5. Intangible drilling costs in any case should be excluded from the Allocation of Deductions Rule. IDC is not truly an LTP item. The theory of ADR is that no cash is expended. IDC involve direct cash outlays in a legitimate search for oil and gas. Inclusion of IDC in the ADR provision is discriminatory against the investor of the independent operator. Therefore, the 60% limitation would be a

disincentive to the independent segment and have no direct affect on the major oil companies. This provision would give a direct competitive advantage to the extremely large operator over the independent segment that historically has discovered more than 75% of our domestic reserves.

6. The suggested recapture rule for intangible drilling costs, upon the sale of the property, would have its most adverse effect upon the small operator who periodically may be forced to sell a discovered lease to retire bank loans and other obligations incurred in drilling and developing the lease. Even Treasury has labeled IDC as "an annual expense" and has always required that IDC be used to reduce depletion allowance in prior years under the net income provision.

7. We object to the retroactive provisions in this regard too, because it is suggested that IDC be recaptured for each year it was claimed as an annual expense since the discovery of the property. This could apply in retrospect for as long as 43 years (Percentage depletion enacted, then). Record retention, sensibility, and any fair Statute of Limitations makes this requirement ridiculous. Having changed the maximum 25% capital gains treatment accorded a transaction involved in the sale of a property, we deem it improper to impose additional tax by use of the recapture feature.

8. The proposed 50% top marginal rate on earned income coupled with other proposed tax changes which affect the investor will work to eliminate him as an oil and gas speculator. The point here is that traditionally, the independent oil and gas operator generates his capital from outside the industry. Major companies generate their capital internally from the sale of products, etc. Looked at in this light, the reduction in the tax rate is a disincentive to investment in oil and gas exploration. Lack of investors will hasten the disappearance of the independent oil man from the scene.

9. Treasury proposals take little note of the fact that commitments beyond the control of the prudent independent may cause an unplanned, heavy, financial investment in any year, thereby turning a profit into a loss for a particular year. Examples are: Offset obligations, farm-out commitments, production problems and expensive completion problems in deep holes.

10. The latter pages of Treasury testimony are an undisguised and lengthy attempt to justify continuation of foreign tax credits, which are actually nothing more than royalty payments in most cases.

11. In addition to the increased tax burden which would be imposed by many of the proposals, the complexities of trying to interpret regulations and filing a tax return would be worse confounded. Some of the proposals would require computation, re-computations and comparisons of computations that would be vexatiously time-consuming and expensive and would leave the taxpayer with no certainty whatever that he had properly interpreted the regulations and properly filed his return.

Rather than simplification, which should be one principal goal of tax reform, Treasury proposals, in our judgment, will create mass confusion in the business community. It will be years before the true impact is fully known. In the meantime, all of us will face enormously increased costs of accounting, appeals and litigation.

All current incentives available to the domestic petroleum industry need to be maintained and improved. Of all of these, the privilege of expensing intangibles is of overriding importance to the domestic segment. But depletion and all the rest are each important—and in different ways and at different times.

We respectfully submit that adverse changes in mineral tax policy will literally devastate the basic economy of our state.*

Although it might be considered slightly academic there is merit in assessing the effect of the decline and even the possible virtual disappearance of the Kansas petroleum industry. What are the plausible impacts of such a situation?

Such a state of affairs can probably be most realistically visualized in terms of the estimated current dollar values generated by the Kansas petroleum industry. Suppose for sake of emphasis, the entire oil industry were to cease; what would this mean in direct and side effects, measured in dollars?

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*Ronald G. Hardy, Chief Mineral Resources Section, State Geological Survey of Kansas. Acknowledgment: Input-output data for this report has been furnished by Dr. Jarvin Emmerson, State Economic Analyst, Manhattan, Kansas.

MEASUREMENT METHOD OF POTENTIAL LOSSES

In order to do this we turn to the system of social accounting known as input-output (1-0) analysis. Because the petroleum industry is a major one in the economy of many regions in Kansas, the impact of changes is significant. Instability in this industry will effect numerous parameters in the private as well as public sectors of the regions economy; in particular it will affect personal incomes and sales and employment in other industries. The demand for land and for local government services and the magnitude of tax receipts will be affected.

The (1-0) analysis simulates these relationships and is therefore a valuable tool with which to measure the impact that changes in any economic activity will have on all other activities, not only after the fact but also for assessing proposed changes.

The data of 1-0 analysis are the flows of goods and services inside the economy that underlie summary statistics by which economic activity is conventionally measured. This technique is essentially a system of double-entry bookkeeping which shows for each sector of the economy purchases from and sales to each of the other sectors during a given period.

POTENTIAL LOSS ESTIMATE

In the light of the foregoing, the Kansas 1965 1-0 analysis shows the following interindustry effects, assuming the Kansas petroleum industry was removed from the economy.

(1) The effect on all other Kansas industry outlays:

(*a*) The crude oil and natural gas production industry has an output of $441 million. If this were to cease it would result in a loss of $660 million in the output of the remainder of the state's industry.

(*b*) Oil field services now has an output of $46 million; removal of this industry would be reflected in a $68 million loss in the remaining state's industries output.

(*c*) The present Kansas petroleum refining industry has an output valued at 580 million. If this were to cease it would create a $1 billion loss in the remaining state's industry sectors output.

(2) The effect on wages and salaries:

(*a*) The crude oil and natural gas production industry now pays wages and salaries of $37 million. If this industry were to disappear it would create a loss of wages and salaries in all of the remaling industries of $169 million.

(*b*) Salaries and wages in the oil field services industry now total $25 million. Loss of this industry would cause a loss of $45 million in all of the remaining state's industries.

(*c*) The refining industry now has a wage and salary payroll of $38 million. Should this be eliminated, there would be a loss of $191 million created in the remainder of the state's industries.

(3) State and local taxes:

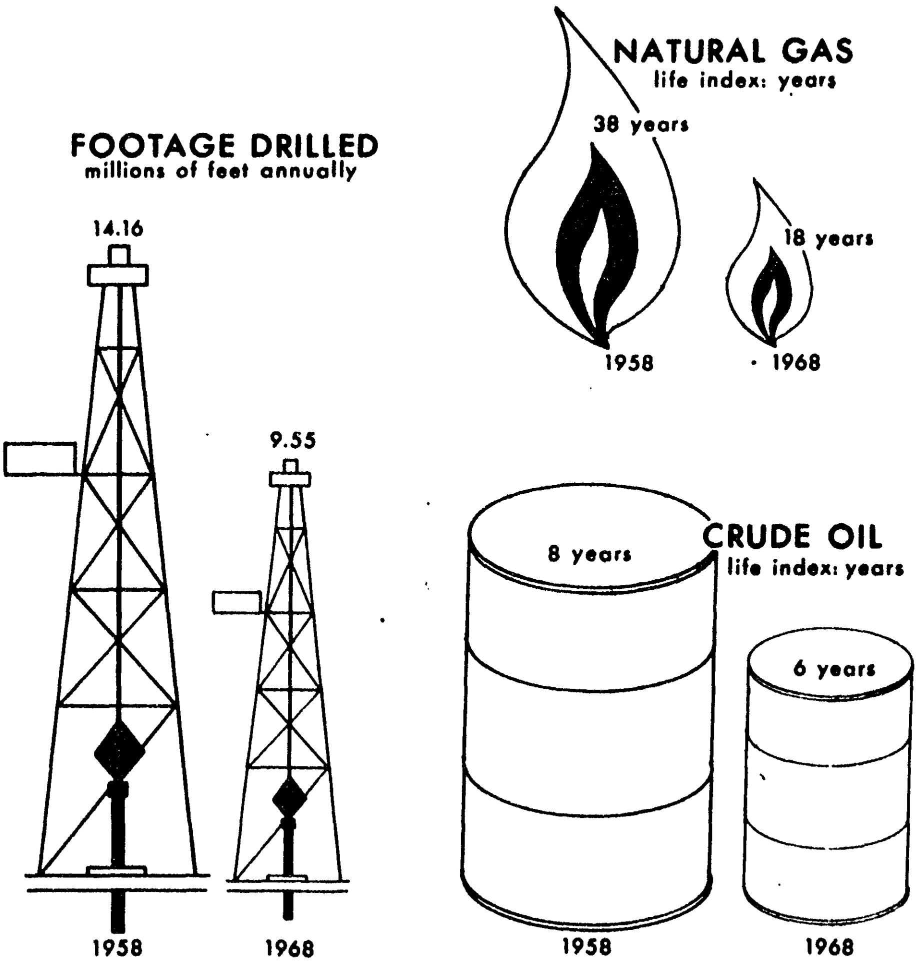
(*a*) The impact of the removal of the Kansas petroleum industry would be a loss amounting to $43 million. About half of this, or $20 million, represents income taxes and since total state income taxes is currently about $10 million this is a loss of 20%.

Summing all of the losses that could occur with the cessation of a Kansas petroleum industry amounts to approximately $3⅓ billion. Total Kansas output for 1965 was close to 25⅓ billion dollars, thus the loss is very close to 13% of this total. The impact of this would result in very serious dislocations in many Kansas regions for a long period of time. The foregoing social cost loss would seem to be a heavy one that in the long run would be less costly to prevent.

Respectfully submitted,

THE KANSAS INDEPENDENT OIL AND GAS ASSOCIATION.

KANSAS Oil and Gas Reserves Shrink as Drilling Declines



A sharp decline in drilling along with a rapid increase in energy consumption has cut deeply into the proven reserves of oil and natural gas in the State of Kansas. Life index is a theoretical figure determined by dividing proven reserves by current rate of production for each year.

KANSAS INDEPENDENT
OIL & GAS ASSOCIATION

September, 1969

STATEMENT OF WILLIAM B. CLEARY, PRESIDENT, OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION, AND PRESIDENT, CLEARY PETROLEUM CORPORATION, OKLAHOMA CITY

SUMMARY

Oklahoma now produces about 600,000 barrels of oil per day which is about 6 percent of total U.S. production. We produce 7 percent of the Nation's gas production and our operating area has about 12 percent of the probable undiscovered U.S. gas reserves in the lower 48. Independents now drill more than 85 percent of the exploratory tests in our state and well over half of the exploratory tests in this country. We expect the major companies to do even less drilling in our area as budgets are shifted more and more to offshore areas and Alaska. *So the burden of finding new domestic reserves of oil and particularly of natural gas falls squarely on us.* In Oklahoma we have not been able to produce enough oil to meet demand for nearly two years and the gap gets larger. The Nation's natural gas supply is dropping at an alarming rate, a fact that is well documented.

Oil and gas exploration is a speculative business. In order to attract capital, return must justify risk. Present prices and tax provisions do not provide enough incentive to have supply meet consumer demand. *Available risk capital has dried up appreciably in the past two months because of present uncertainty over the tax laws.* The effect of the present tax handling of non recoverable so-called intangible costs will be covered by other witnesses. *Percentage depletion,* the principal subject of this testimony, *serves a vital function on the return side of the risk return formula.*

The percentage depletion concept is sound. We deplete our capital assets when we produce our oil and gas. An oilman can be likened to an apple farmer who cuts off a limb with each apple so that when his crop is harvested he has no more tree, no crop next year. Depletion acknowledges this depleting asset concept and says that a portion of the apple crop should be set aside before tax liability so that new land can be bought and new trees planted. The risk of crop failure for oilmen is extremely high. The tax climate for oil and gas has a very considerable effect on whether our crops will flourish or wither and die.

Current tax laws provide an artificial limitation on that depletion which renders it largely ineffective when it is most needed. This 50 percent net income limitation accounts for the fact that Oklahoma producers we have surveyed get about 21 percent actual percentage depletion rather than 27½ percent. We therefore urge that this 50 percent net income limitation on any percentage depletion be eliminated.

The consumers domestic energy needs are outrunning our supply capability, particularly in natural gas. If present trends continue, the consumer won't have anything to consume. Any politically feasible change in the present tax laws which will help rather than hurt incentive to find new reserves should be carefully considered. *We strongly recommend removal of the 50 percent net income limitation on depletion.*

STATEMENT

I am William B. Cleary, President of Oklahoma Independent Petroleum Association representing more than 800 independent oilmen in Oklahoma. I'm also President of Cleary Petroleum Corporation, Oklahoma City. Our company drills about fifty wells a year. Our state has significant oil and gas reserves both producing and undeveloped. We currently produce about 600,000 barrels of oil per day which represents about 6 percent of total U.S. production. We produced about 1.5 trillion cubic feet of gas last year which represented about 7 percent of the Nation's gas production. The area we operate in has about 12 percent of the probable undiscovered U.S. gas reserves according to a study by the Colorado School of Mines Mineral Resources Institute, Potential Gas Agency Branch. (See attached map, Exhibit A).

Oklahoma independents do about 85 percent of the drilling in the state and are directly responsible for about 40,000 jobs in the state. Under present prices and existing tax provisions we have not been able to keep up with growing demand for new oil and gas reserves in our area and this situation is now approaching a critical stage. For more than 20 months demand for Oklahoma crude has exceeded supply, and the gap gets larger (Exhibit B). The supply situation in natural gas is even more critical. Mr. John O'Leary, head of the Bueran of Mines, has warned of the approaching critical shortage of natural gas. Mr. John Nassikas, head of the Federal Power Commission has also expressed his concern about our dwindling supplies as have other members of the FPC (see Exhibit C). Every gas well my company has which sells to interstate pipelines is selling at more than contract rates where the well is capable of producing additional gas. Three years ago the FPC staff spoke of fifteen to seventeen years of natural gas supply. The head of the FPC stated earlier this month that a new study indicates we may now have a ten years supply. My own experience tells me the figure is likely to be considerably lower than that.

Independents have been drilling more than 85 percent of the new oil and more important new gas wells drilled in our state. With major oil company budgets being committed to the North Slope and Offshore, I expect that percentage to increase, if we independents are still in business when the new tax law becomes effective. I can honestly say that if we don't do the exploring I don't know who will.

Ours is a speculative business and in order to attract risk capital (and more than 70 percent of our risk capital comes from outside the oil business) cost, risk and ultimate return must be balanced. If incentives are too great supply exceeds demand. If incentives are not great enough demand exceeds supply and that is the condition now.

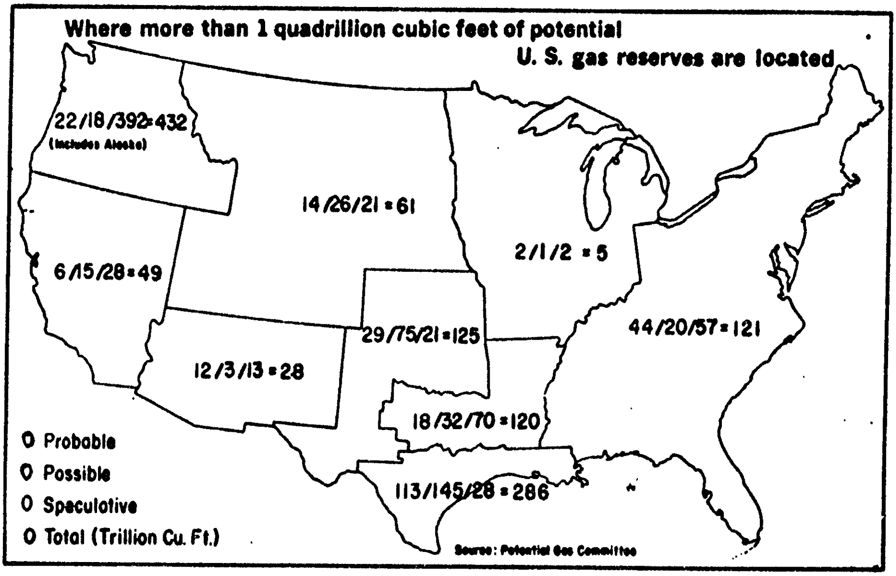
Others here will testify as to the effect of the present tax handling of non recoverable costs on the cost side of this teeter-totter.

I would like to tell you of the importance of depletion on the ultimate return side and make a suggestion regarding depletion. Risk capital for oil and gas exploration is a fragile flower and it withers easily. We have already seen a marked decline in availability of risk capital as a result of the present tax deliberations. If producers after tax costs are increased our ultimate return is reduced and supply must suffer. The consumers cannot force producers to take unjustified risks.

The percentage depletion concept is a sound one. Oil and gas in the ground is a capital asset and when it is produced it should be taxed as a depleting capital asset rather than as an asset which can produce continuing income. An apple farmer pays an income tax on the sale of his apples because he can produce them year after year. An oilman depletes his total asset with each barrel he removed from the ground. If he were an apple farmer you could think of him as cutting off a bit of the tree with each apple he harvests so that when his harvest is complete he not only has no more apples but he has no more tree. Rather than tax the whole crop as income, a portion of this crop has wisely been set aside to be free of tax so that he can plant another tree and try again. I can assure you the risk of crop failure is extremely high, and changes that have been proposed in the tax climate will make the attrition even higher.

Where does depletion come into the picture? It of course affects the amount of money an investor in oil eventually has in his pocket, after paying all the bills. It controls his ability to try again. We have all head a great deal about the perhaps unfortunate symbol of 27½ percent depletion. The symbol is an unfortunate one particularly for Oklahoma producers, because an Oklahoma University Bureau of Research survey conducted earlier this year showed that independents in our state average around 21 percent depletion rather than 27½ percent. The difference comes about because of the *limiting factor* in the present law which is *virtually unknown to most tax payers outside the oil business.* It says that percentage depletion shall be limited to 50 percent of the net income from a given property. Let's see how this works. In Oklahoma our average per well production last year was a little over 7 barrels of oil per day. The national average, because of flush new production in Montana, Texas and Louisiana, averages about 12 barrels per day. This is marginal production but it is production the Nation can ill afford to lose. It costs as much to produce a 7 barrel well as it does a 100 barrel well, and frequently costs more. For the producers who has $100,000 a year in oil and gas sales with production like this, costs of production might easily be $80,000 leaving him a net income of $20,000. Percentage depletion on his $100,000 sale would say that he should have $27,500 available for replacement of reserves before incurring tax liability. The 50 percent net income limitation however says that his depletion cannot exceed half of his net income. His net income was $20,000, so his percentage depletion would be $10,000 and he'd pay tax on the other $10,000. This restriction puts a particular penalty on the independent producer and the penalty is most burdensome in the marginal years of production when the producer has the greatest need for reinvesting his money in the search for more oil and gas.

Our Nation's domestic energy needs are outrunning our supply capability at increasing rates. When you consider the incentives the producing segment of the industry needs in order to fulfill the consumers demands at the stove and the gasoline pump, I urge you to consider removal of the net income restriction on percentage depletion. It would help offset the adverse effects on incentive of any reduction in percentage depletion. It is politically feasible. It would be particularly beneficial to the independent segment of the industry.



Undiscovered U.S. gas reserves total 1,227 trillion cubic feet

THE POTENTIAL GAS COMMITTEE estimates undiscovered natural gas reserves in the United States total 1,227 trillion cubic feet—nearly double the Committee's estimate of 690 trillion cubic feet two years ago.

Reasons for the increase: Alaska's reserves are included for the first time (400 trillion cubic feet); water depths for offshore reserves were increased from 600 feet to 1,500 feet; well depths were increased from 25,000 feet to 30,000 feet.

The new PGC report explains that nearly one-third of the total undiscovered natural gas supply is in Alaska, and will not be available to markets in the "lower 48 states" until pipe lines are built, or until gas can be liquefied and moved south in tankers. The increases in water and well depths add several hundred trillion more cubic feet to the total.

The Committee estimate is divided into the following categories: probable supply—260 trillion cubic feet; possible supply—335 trillion; and speculative supply—632 trillion. These totals are in addition to 287 trillion cubic feet of proved recoverable reserves, as of December 31, 1968.

For the first time, the PGC reports U.S. potential natural gas supply by nine supply areas (See map). Boundaries of each region coincide with the boundaries used by the American Gas Association Proved Reserves Committee. Two years ago the report was divided into estimates for three areas: East, Central and West U.S. Offshore Gulf Coast undiscovered supply for Louisiana and Texas is separated from the onshore supply for the first time.

The 150-member Potential Gas Committee is sponsored by the Colorado School of Mines' Mineral Resources Institute, Potential Gas Agency branch. The Agency's activities are financed by the American Gas Association, Inc.; the American Petroleum Institute; and the Independent Natural Gas Association of America.

The report emphasizes that huge gas reserves remain to be found, but "economic incentives must be provided to encourage people to go get it."

In recent years, fewer and fewer wells have been drilled in search of new reserves. As a result, the American Gas Association reports that in 1968, for the first time since World War II, the U.S. used more gas than it discovered—by 5.5 trillion cubic feet. Reserves were increased by 13.5 trillion cubic feet, but consumers used 19 trillion cubic feet. ■

EXHIBIT B

[From the Daily Oklahoman, Sept. 24, 1969]

OKLAHOMA CRUDE DEMAND STILL OUTPACES PRODUCTION

(By Deacon New)

Demand for Oklahoma crude oil continues firm, outstripping the state's productive capacity.

Crude purchasers told the state Corporation Commission Tuesday they need 631,090 barrels daily next month, an 11,267-barrel jump over September requests.

The nominations totaling 631,090 barrels a day compares with pipeline runs during August averaging 607,468 barrels a day. Output the first 13 days of September is runiing about the same rate, 606,954 barrels daily.

Most purchasers testifying at the commission's market-demand hearing recommended continuation of the current 100 per cent factor applied to the basic depth-acreage allowable table.

Dan R. Dunnett, director of the commission's oil and gas conservation department, also favored holding the allowable at the same rate.

Dunnett said the Bureau of Mines forecast of demand for Oklahoma crude during October at 620,000 barrels a day, the same as the September estimate.

Wilburn Cartwright, commission vice chairman, presided at the hearing in the absence of the chairman, Charles Nesbitt. Nesbitt is in Alaska attending an Interstate Oil Compact Commission executive committee meeting.

Cartwright and Ray C. Jones, who heard the purchasers' testimony, said the October allowable will be set later this week.

The increase in the total nominations was more than accounted for by a boost in the request of Mobil Oil Corp. Mobil increased its nomination 12,500 barrels to 48,200 barrels a day. The company's purchases totaled 55,899 barrels a day during August.

George Stricker, representing Mobil, told the commission the increased nomination represented a firm demand for Oklahoma crude.

The purchasers, reporting on company-wide stocks, said total inventories as of September 1 were 9,570,844 barrels above desired level. That compares with a surplus the month before of 17,023,597 barrels.

A breakdown showed crude stocks at 7,493,426 barrels on the plus side, while products in storage were 2,077,418 above desired level.

	Actual production BOPD	Crude buyers nominations BOPD
1968—		
January	604,000	644,000
February	618,000	650,000
March	620,000	643,000
April	628,000	636,000
May	613,000	634,000
June	610,000	630,000
July	614,000	628,000
August	614,000	628,000
September	610,000	628,000
October	606,000	626,000
November	610,000	619,000
December	612,000	616,000
1969—		
January	615,000	615,000
February	619,000	634,000
March	609,000	635,000
April	626,000	628,000
May	610,000	642,000
June	617,000	637,000
July	608,000	619,000
August	607,000	619,000

Note: State allowable was at 65 percent of table A maximum January 1968 through May 1968. From then through the end of 1968 it was 75 percent and early in 1969 went to 90 percent. It has been at 100 percent since March and production is declining.

EXHIBIT C

NASSIKAS MEANS BUSINESS ON GAS SUPPLY

New FPC chairman sees no lack of evidence that gas is in short supply and fast getting shorter, says he doesn't need national survey to precede action. If higher price is solution, he'll likely buy that.

(Gene T. Kinney, Washington Editor)

The new chairman of the Federal Power Commission doesn't intend to wait for a national gas survey before doing something about a growing supply problem.

This presumably means raising wellhead prices, if it appears this is the likely solution.

John N. Nassikas, who took office Aug. 1, expresses confidence FPC has the flexibility to help turn supply trends around.

Named by President Nixon to suceed Lee C. White, Nassikas revealed his attitude in an interview last week. It contrast sharply with that of his Democratic predecessor.

White never really conceded there was a supply problem, in spite of a 5½-trillion-cu-ft decline in reserves last year. He led the commission in a deep slash of rates in South Louisiana, the most important producing area in the nation—a move hardly calculated to boost reserves. Moreover, he contended a study of some kind, such as the survey he pushed unsuccessfully, was necessary to establish the facts.

Nassikas, the 52-year-old Republican lawyer from Manchester, N.H., has found plenty of evidence of declining supply. He cites studies by industry groups and FPC's own staff.

In his view, past FPC decisions—notably in the Permian basin and South Louisiana—and rulings of the Supreme Court have not frozen present producer rates. Quite the opposite, he says. In Permian, he stresses, the high court affirmed FPC's wide discretion in using varying price levels to bring forth adequate supply.

FPC study. Nassikas, after 6 weeks on the job, considers the evidence of supply trouble to be "rather convincing."

He cites the annual report of proved reserves by the American Gas Association and other studies, including one by the FPC staff.

"All confirm an increasing problem with gas supply," he says.

The FPC study, to be published soon, shows a deliverability life from present reserves of only 10 years, the chairman discloses.

In view of increasing demand and recent declines in reserves. Nassikas believes the supply-demand curves will intersect much sooner than 10 years from now, unless the supply trend is reversed.

"When you have that close a margin," he declares, "a critical supply situation exists."

Top priority given. In view of this situation, the FPC chairman says the "overriding priority of FPC is to make sure to resolve on a practical, expeditious basis the gas-supply problem in the United States."

Unless this is done on a short-term and long-term basis, FPC is not doing justice to a $30-billion industry, its investors, and consumers who rely on it.

Nassikas says he became somewhat familiar with FPC issues during the past year as counsel to the minority on the Senate Commerce Committee, which has legislative oversight of the agency. Also, he took a cram course beginning last April, when he became aware of the President's intention to install him as chairman of FPC.

Since that time, he says he has become convinced that the supply issue deserves priority attention. He rejects any thought of "rationing scarcity," as a solution, preferring instead a "share abundance."

A national gas survey may be desirable, he says. "But absence of a survey is no excuse for delay in meeting a problem that is manifest."

Problem cause. Nassikas refuses to attribute the reserves decline directly or solely to FPC's policies of keeping the lid of producer prices.

But he does quote with approval an economic axiom stated by Milton Friedman. The surest way to achieve a shortage in a commodity, according to the economist, is for the Government to impose a price ceiling that is too low.

The new chairman plans first to determine what has caused the decline in drilling, the slide in the reserves-production ratio and deliverability life, and, last year, the absolute drop in proved reserves.

If FPC finds that its price policies have been responsible, he says, then these policies should be reversed.

He says FPC must ascertain whether price alone offers adequate incentive or disincentive to control the supply of gas. And he suggests that assurance of a firm price once approved may be almost as important as the price level itself.

The industry has drafted proposed contract-sanctity legislation that would prevent future FPC rollbacks of prices once approved. But no drive has been mounted to push the legislation.

The cure. Once the cause of present supply trends is established, Nassikas says, the policy actions should be fairly clear.

He expresses confidence FPC machinery is not so cumbersome it cannot deal with the situation. He says the commission has several possibilities, without commenting on any of them.

He acknowledges that the commission has set "permanent" rates in the Permian basin and South Louisiana. The first case was upheld 100% by the Supreme Court, and the second is before the Fifth Circuit Court of Appeals with oral argument set for Oct. 6.

FPC and the courts are bound to decide these cases on the facts and circumstances in the record.

But, Nassikas points out, the FPC and the courts can set new rates, or adopt new formulas, in subsequent cases, if the facts or circumstances change.

This is the principal argument of producers, pipelines, and a large group of distributors—that circumstances have changed, requiring higher rates to avoid a threatened shortage.

Nassikas says FPC is already making "policy decisions" aimed at dealing with the question.

Last week the commission set oral argument on two pending rate cases for Oct. 31. These deal with producer prices in the big Texas Gulf Coast and Hugoton-Anadarko regions, pending before FPC on examiner's decisions since Sept. 16, 1969.

The commission also has before it a reopened proceeding embracing the federal offshore portion of South Louisiana, and a settlement proposal for Hugoton-Anadarko. There are also motions to expand the offshore proceeding to include onshore Louisiana as well, and even motions to consider a national proceeding.

Nassikas believes FPC has wide discretion in dealing with supply, and even the contract sanctity question.

Favors regulation. FPC is duty-bound to act so that the industry will be able to meet future gas demand, Nassikas believes.

If it finds itself impotent to solve the problem, then he feels the commission should recommend appropriate legislation.

But decontrol—or regulation within narrowly defined limits under legislation—is not the best approach, as far as he is concerned.

Under present statutes and court rulings, FPC ought to be able to respond to particular problems, he says. He declines to lay the blame for any current troubles on restrictive court decisions. The courts, he emphasizes, have not put FPC in a strait jacket.

"We should improve the concept of producer regulation, not discard it because we happen to have a problem."

He also opposes the Burleson bill, which would require regulatory agencies to gear rate of return to inflationary trends. Pipelines have sought this legislation as a solution to their rate-of-return problem.

But this approach, the chairman warns, would only lead in the long run to broader problems than the narrow one the legislation is designed to solve.

"The regulatory process itself," he declares, "is the appropriate forum to resolve inflation problems or any other pressures to erode rate of return, rather than use the legislative approach when FPC may in the past have failed to resolve the problem."

New staff appointments. Nassikas promises to begin announcing, perhaps in less than a month, new appointments to the Office of Executive Director, chief of the Bureau of Natural Gas, and deputy chief of the bureau.

He declines to say whether he will replace the present general counsel, Richard Solomon.

Nassikas says he is seeking qualified men of integrity, familiar with the regulatory process and the problems of industry, consumers, and investors. Top staff members also should be aware of the impact of FPC decisions on regulated industries, he adds.

Action, not talk. Nassikas gives the impression of a man who is not at all intimidated by the immensity of the problems facing FPC.

He shows sign of becoming an activist chairman willing to take initiative where departures from present policies seem called for. And the initiative won't be long in coming, if his present plans are realized.

"I am talking about a series of regulatory decisions which we will be in the process of making this year," he says. "We will start soon. I am not talking about a thinking process of a couple of years. We have gone through that process and are formulating policies designed to deal with the gas supply and deliverability problems."

TWO JURISTS PICKED IN ALGERIA FUSS

Atlantic Richfield Co. last week said that two of the three judges on an arbitration court to rule on its dispute with Algeria have been appointed.

Under the rules, one judge is to be named by the International Court of Justice at the Hague, and one by each of the dissenting parties.

The International Court of Justice named Prof. Giorgio Balladore Pallieri of Milan, Italy, a judge at the European Court of the Rights of Man, as president of the aribtration court.

ARCO then announced its appointment of Prof. Francois Luchaire of the University of Paris, a member of the French Constitutional Council, as the second member.

So far, the Algerian Government has not announced its appointment of the third judge, and there's no guarantee it will deign to do so.

A spokesman for Sinclair Mediterranean Petroleum Co., the ARCO subsidiary whose Algerian properties are at stake, said that Dr. Jose Luis Bustamente y Rivero, president of the International Court, had advised the company of Pallieri's appointment and said the Italian barrister had accepted.

Sinclair Mediterranean announced last May 13 that it was initiating the arbitration proceedings to protest the forfeiture of its properties to the Algerian Government. Principal of these is a 28% interest in Rhourde el Baguel oil field, where Sinclair's share of production was 22,981 b/d in 1968. There was no return to the company, however, since it has been under Algerian Government control since June 1967.

STATEMENT OF THE PANHANDLE PRODUCERS AND ROYALTY OWNERS ASSOCIATION, AMARILLO, TEX., PRESENTED BY C. H. HINTON, PETROLEUM CONSULTANT

SUMMARY

The scope of my statement covers statistics on the recoverable natural gas reserves for the period ending each year from 1955 through 1968. It also shows the annual production for the same period and the number of well completions in the United States extending over the same period. This is shown in graphic and schedule form.

My statement also covers the estimated gas requirements for the future up to 1990.

I have made an effort to point out why there has been a decline in the number of wells drilled in the United States; why it is essential for the number of wells to be increased to a level of twice the 1968 number; and why the removal of any existing tax deductions would have an adverse effect on drying up drilling funds that would cause a further reduction in the number of well completions.

I have discussed the reserve life index or the ratio of production to reserves and explained that the use of such reserve life index as a yardstick for the life of natural gas reserves furnishes the most optimistic picture of the availability of natural gas for the future.

The producers have been classified as the pipeline producers, large independent producers, and the small independent producers, with the contribution that each makes to the natural gas supply.

My entire statement has been reduced to four Conclusions which are of importance in the action which this committee might take with respect to reducing statutory depletion, or removing intangible drilling costs as income tax benefits.

CONCLUSIONS

1. It is an indisputable fact which must be faced—that there is a very serious shortage of natural gas being developed in the United States.
2. If future requirements are to be supplied, the number of well completions must be doubled over the 1968 level in the shortest possible time.
3. There are thousands of yards of sediments which are estimated to be productive of natural gas that have not been tested by the drilling of wells.
4. Any downward reduction in statutory depletion, or any reduction in intangible drilling costs as a tax reduction will cause a further decline in the number of well completions.

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STATEMENT

My name is C. H. Hinton. I reside in Amarillo, Texas. My office address is 1012 West Tenth Street. I am a petroleum consultant and President of Consulting Services, Inc.

For the past 33 years I have spent a major part of my time on problems related to natural gas supply and the requirements for natural gas.

I am a member of the National Society of Professional Engineers; the Society of Petroleum Engineers of the American Institute of Mining and Metallurgical Engineers; the Texas Professional Engineers; and I am a registered professional engineer.

I am appearing here today as a member of, and in behalf of, the Panhandle Producers and Royalty Owners Association.

The Gas Supply Situation from 1955 through 1968

In order to present a clear picture of gas supply trends and the increase in the annual requirements to supply markets, I prepared three graphs which are attached to the back of this statement.

Graph No. 1 shows the recoverable natural gas reserves for the 14 year period 1955–1968. At the top of each bar the reserve is shown as of the end of the year in trillions of cubic feet. Immediately to the right of the recoverable reserve is a bar which shows the gross additions to reserves for each of the years. Your attention is called to the fact that back in the mid-50's the gross additions to reserves were more than twice the annual volume of gas produced. In 1968, for the first time in the history of the natural gas industry, production was greater than the additions to reserves. To the extreme right is a bar which shows the annual production. It can be noted that annual production has almost doubled from 10.1 trillion cubic feet in 1955 to 19.4 trillion in 1968.

The reserve life index is shown by years for the period and has declined from 22.1 years in 1955 to 14.8 years in 1968. The reserve life index is obtained by dividing the annual production into the year-end recoverable reserves.

The American Gas Association has caused to be formed a Gas Industry Committee to study the future gas requirements of the United States. It is estimated that the requirements will increase to 25.5 trillion for the year 1975 and 36 trillion by the year 1990. In order to present the upward trend in natural gas requirements, Graph No. 3 was prepared and is attached hereto, which shows the annual increase in natural gas requirements.

The interstate pipeline companies have been unable to contract the full volume required to meet present and estimated future requirements for the past few years. The reasons that there are inadequate volumes for interstate transportation to supply the United States requirements are:

(1) the reduction in the number of well completions, and

(2) the gas requirements in the producing states, particularly Texas and Louisiana, have increased at a very substantial rate.

A schedule which shows gas volumes and reserve life index in more detail is attached to this report and is shown as Schedule 1(a).

History of the number of wells drilled in the United States

The downward decline in the number of well completions in the United States is shown on Graph No. 2 with the detailed numbers on the schedule numbered 2(a) which both appear at the back of this report.

The largest number of wells ever completed in the United States in any one year occurred during the year 1956. That year 57,111 wells were drilled in the United States, of which 35,273 were productive of oil or gas and 21,838 were dry. There has been a decline in the number of wells drilled since 1956 down to a low since World War II of 30,599, of which 17,612 were productive of either oil or gas and 12,987 were completed as dry holes or non-producers.

The question arises as to why there has been such a drastic reduction in the number of wells drilled in the United States over the past 13 years. I will set out the principal reasons which have caused this reduction:

1. The method of Federal Power Commission regulation as applied to wells which were drilled by the pipeline producer. A pipeline producer is a company engaged in the finding and development of gas reserves and is also engaged in the interstate transportation of natural gas. Since 1941, as a result of a Federal Power Commission decision in the Hope Natural Gas rate case, all pipeline producers were placed under the regulation of the Federal Power Commission and the price which was permitted to be charged for natural gas was based on a utility cost of service concept. The impact of this type of regulation on producing properties caused the pipeline to reduce its production activities as this type of risk capital investment cannot be expended where the regulation is determined on a cost of service basis. The incentive for the pipeline producer to continue to look for and develop gas reserves was further retarded when the Federal Power Commission took the position that all statutory depletion should pass directly to the consumer as a reduction in the amount of income tax that is to be paid and included as a part of the cost of service.

2. The Supreme Coure decision in the Phillips case, handed down in June 1954, placed the non-pipeline producer under the jurisdiction of the Federal Power Commission as to the price which might be paid for natural gas that was contracted to be sold in interstate commerce.

After years of lengthy hearings the Federal Power Commission proceeded to regulate the price of natural gas by putting into effect area guideline prices and would not accept contracts for filing which provided for prices higher than the area guideline prices. Even after all of the hearings, which cost the producer and the government millions of dollars, the area guideline prices correspond very closely to prices which were being paid for gas on contracts made prior to 1960 and contracts which were entered into after 1960. Thus, the industry has lived for nine years under prices which were determined at the 1960 level.

During the period 1960 through 1968 you will note that there has been a very alarming decline in the number of wells drilled in the United States.

3. Each year during this period there has been an increase in the barrels of oil which have been imported into the United States. Imported oil does not add to the natural gas reserves. For many years the natural gas which was produced in conjunction with the production of oil supplied approximately ⅓rd of the total

natural gas consumed in the United States. The reduction in the number of well completion in the United States in the face of the increased gas requirements has lowered this percentage and for 1968 only approximately 20% of the total gas was supplied from oil-well gas.

4. The oil industry is concentrating on obtaining an increasing percentage of the domestic production through secondary recovery operations. This secondary recovery oil is obtained by methods of driving oil to the well bore by water flooding, gas injection, and utilization of other liquids by injecting materials into a reservoir which will no longer produce economic amounts of oil.

Secondary recovery operations make very little contribution to the gas supply as the primary production of oil generally utilizes both gas-cap gas and solution gas.

Reserve life index

I have explained that the reserve life index is an arithmetic computation which shows the number of years of life that the recoverable reserve would last if produced at an annual rate which is equivalent to the annual volume produced during any year. Reserve life index, however, does not give consideration to any increase in future requirements or any additions to recoverable reserves.

A natural gas well loses a portion of its physical ability to produce gas with each one thousand cubic feet produced, and, in general, natural gas wells will be depleted to the extent that the wells will have very little peak producing ability after about the first 12 years of production where the gas is produced in accordance with the contract provisions determining the quantity which may be produced. There is normally a lag of two to three years from the completion of wells in a new reservoir to the date of first production and sale. Thus, the portion of the recoverable reserve available for the consumer supply is narrowed down to 11 to 12 years.

Cycling operations which are carried on in the United States tie up approximately the equivalent of 20 trillion cubic feet, which further reduces the volume available to the consumer.

Therefore, when the reserve life index is determined on the gas connected to the pipelines it is from three to four years less than is shown by the simple computation of dividing the annual current production into the recoverable reserves.

Analysis of future gas requirements

The estimated demand for natural gas required in the future should receive the complete attention of Congress, the consuming public, and the transporter and producer of natural gas. The drastic reduction in the number of well completions and the historical annual increases in the gas requirements, coupled with the estimated future requirements, create a problem which cannot be ignored.

If present and future customers are to be served a continuing supply of natural gas, there must be a broad change in regulatory bodies having jurisdiction over price. Please bear in mind that of the total amount of money which has been invested by interstate pipeline companies and distributors who receive the major portion of the gas from interstate companies, approximately 71% of such investment remains to be depreciated. Unless there is an increase in the gross additions to reserves much greater than has been experienced over the past few years, new depreciation rates will have to be placed in effect in order for the investor to recoup his money. This means a higher cost to the consumer for the same limited supply of natural gas.

Producer Classification

The producers of natural gas fall into three general classifications:

1. The pipeline producer who can no longer be classed as a major contributor to the production of natural gas. The pipeline producer volumes have declined from more than 50% of the total requirements during the early life of the long distance interstate pipeline companies to approximately 8% of the total gas produced.
2. The major producer of natural gas is usually an integrated company that carries on manufacturing activities requiring hydrocarbons and this group has, over the past few years, drilled from 30 to 35% of the total wells drilled.
3. The most important contributor to oil and gas discoveries and development is the smaller independent producer whose principal business is the drilling of oil and gas wells and the production therefrom.

The small independent drills from 65 to 70% of the total number of wells drilled in the United States. While the big acreage sales are bid in by the major oil companies, in most cases such companies have adequate collateral and income from sources other than production to make the financing of the major acquisitions possible, but the small independent producer group makes the greatest contribution to domestic gas reserves.

In the majority of projects the small independent producer receives the money utilized in the drilling wells from independent investors who invest risk capital solely from the standpoint of the reduction in federal income taxes which would otherwise be paid. The removal of intangible drilling costs as a tax deductible item would promptly dry up drilling funds received from such investors. The lowering of statutory depletion from 27½% to 20% would likewise contribute to a lack of drilling funds from investor sources.

Natural gas has established itself as a highly desirable heat energy source which has been supplied in the desired volumes at a price which has been lower than other competitive sources of energy. The finding and development costs have gradually increased to a level where greater incentives must be provided for continuing development.

Impact of a lessened incentive for the producer to drill

If tax incentives for the drilling of oil and gas wells should be adjusted downward, it removes a source of funds that have been available for such drilling.

The question has often been asked—why the number of well completions have declined with the present tax deductions. The answer is relatively simple.

Under the present price structures which cover the cost of finding and development and the income which is generated at current oil and gas prices, the margin of profit is inadequate to induce the expenditure of risk capital and the drilling of wells in the search of oil and gas is certainly of a high risk nature. It is evident that a higher price must be paid for oil and for gas in order to have the number of wells drilled which will supply current and future requirements. Any downward adjustment in the existing statutory depletion, or the allowance of intangible drilling costs, can only cause a higher price to be paid for the oil and gas which will be produced.

Example of how statutory depletion and intangible drilling costs really work

The existing tax regulations are applied to an investor who advances $1,000,000 for the search and development of natural gas. Based on statistics, approximately 50% of the $1,000,000 will be spent on non-productive drilling. This amount will be totally deductible for income tax purposes. The other 50% of the drilling fund would be required to drill 4 wells to a depth of approximately 8,000 feet. The average reserve per well drilled to that depth has averaged out approximately 5 billion cubic feet per well. The gross income from such a well under existing contract terms used in the industry would amount to $37,168.00 per year. Gross production taxes range from 5.4% to 7.5%. Ad valorem taxes amount to approximately 20% of the investment and operating costs range from 5% to 10% of the gross income. The taxable income after the application of the statutory depletion amounts to approximately $10,000 and the income tax for the private investor would amount to about $7,000 per well.

If the investor did not advance these funds on the basis of obtaining the tax deductions, the wells would not have been drilled and the local community would not have the benefit of the industry employing personnel to drill and operate the wells; the state would not have the benefit of the gross production and ad valorem taxes; and the federal government would not have the benefit of the income tax.

The same million dollars could be invested in tax-exempt bonds and make approximately 50% of the same amount of money without taking a risk of losing the entire amount.

Conclusions

1. It is an indisputable fact which must be faced—that there is a very serious shortage of natural gas being developed in the United States.

2. If future requirements are to be supplied, the number of well completions must be doubled over the 1968 level in the shortest possible time.

3. There are thousands of yards of sediments which are estimated to be productive of natural gas that have not been tested by the drilling of wells.

4. Any downward reduction in statutory depletion, or any reduction in intangible drilling costs as a tax reduction will cause a further decline in the number of well completions.

U.S. NATURAL GAS RESERVES AND NET PRODUCTION HISTORY REDUCED TO RESERVE LIFE INDEX

[All volumes in millions of cubic feet at 14.73 p.s.i.a. and 60° F.]

Year (A)	Total reserves end of year (B)	Net additions to reserves (C)	Net production during year (D)	Gross additions to reserves (E)	Reserve life index (F)
1954	210,560,931				22.4
1955	222,482,544	11,921,613	10,063,167	21,948,780	22.1
1956	236,483,215	14,000,671	10,848,685	24,849,356	21.8
1957	245,230,137	8,746,922	11,439,890	20,186,812	21.4
1958	252,761,792	7,531,655	11,422,651	18,954,306	22.1
1959	261,170,431	8,408,639	12,373,063	20,781,702	21.1
1960	262,326,326	1,155,895	13,019,356	14,175,251	20.1
1961	266,273,642	3,947,316	13,378,649	17,325,965	19.9
1962	272,278,858	6,005,216	13,637,973	19,643,189	20.0
1963	276,151,233	3,872,375	14,546,025	18,418,400	19.0
1964	281,251,454	5,100,221	15,347,028	20,447,249	18.3
1965	286,468,923	5,217,469	16,312,852	21,530,321	17.6
1966	289,332,805	2,863,882	17,458,527	20,322,409	16.6
1967	292,907,703	3,574,898	19,064,779	22,639,677	15.4
1968	287,349,852	(5,557,851)	[1] 19,373,428	13,815,577	14.8

[1] 1968 net production, preliminary number.

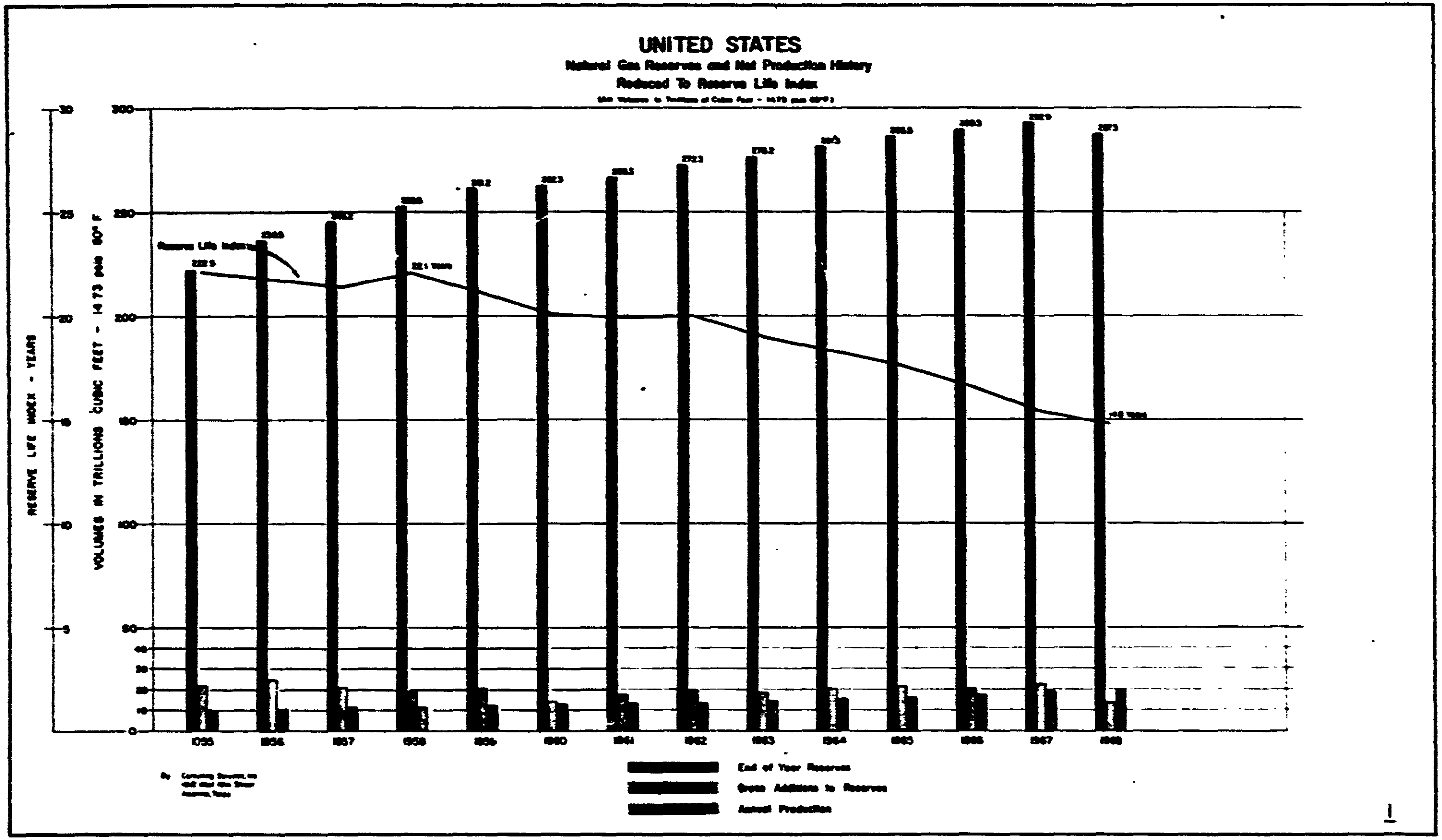
Note: Includes Alaska (reserve as of Dec. 31, 1968, 5,252,324 MMCF; 1968 production, 41,681 MMCF).

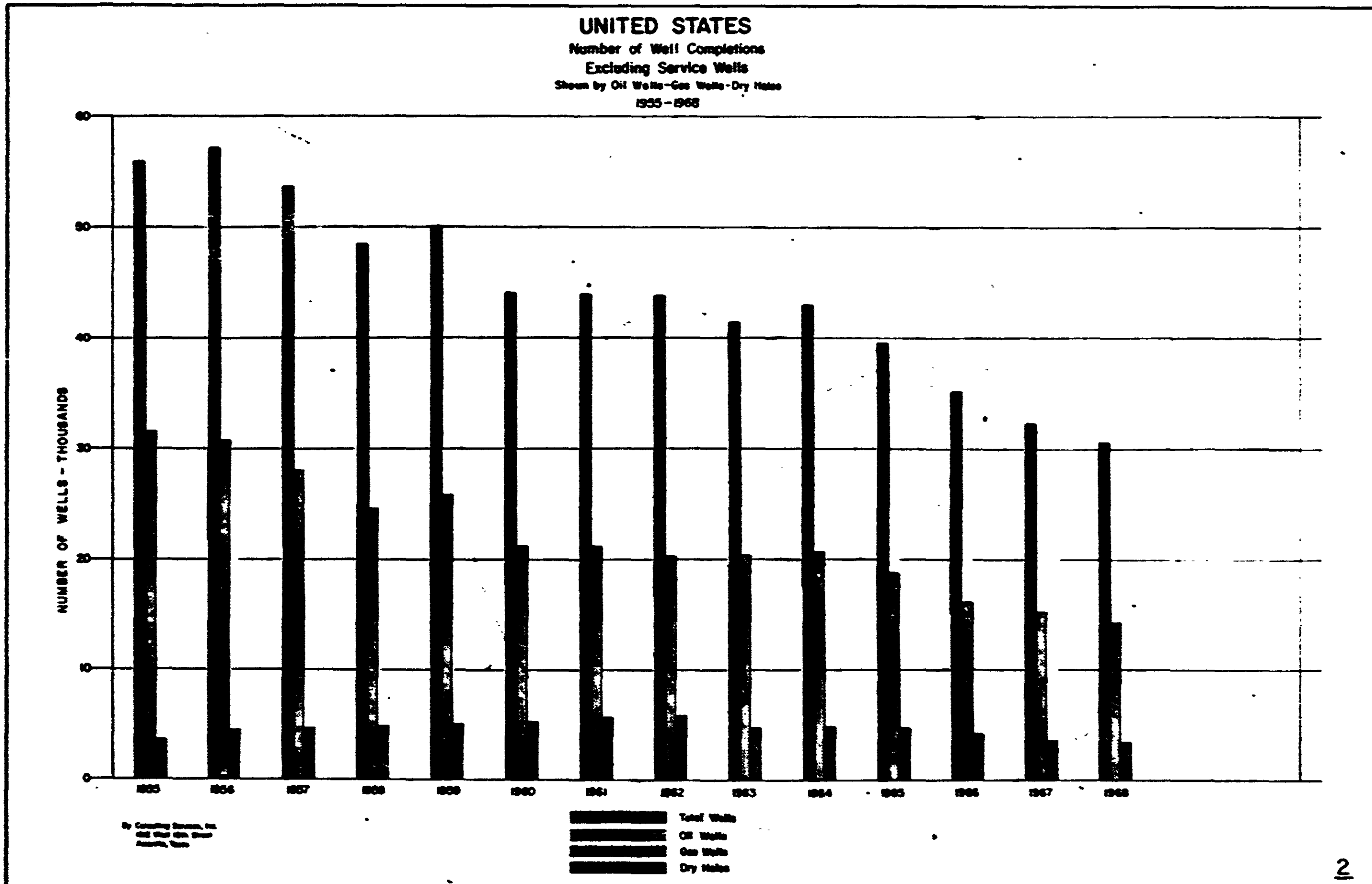
Source: Reserves of crude oil, natural gas liquids, and natural gas in the United States and Canada as of Dec. 31, 1968. Pp. 120 and 126. Historical Statistics of the Gas Industry.

NUMBER OF WELL COMPLETIONS (EXCLUDING SERVICE WELLS) SHOWN BY OIL WELLS, GAS WELLS, DRY HOLES (UNITED STATES)

Year	Type of well				
	Oil	Gas	Producers	Dry	Total
1955	31,567	3,613	35,180	20,742	55,922
1956	30,730	4,543	35,273	21,838	57,111
1957	28,012	4,620	32,632	20,983	53,615
1958	24,578	4,803	29,381	19,043	48,424
1959	25,800	5,029	30,829	19,265	50,094
1960	21,186	5,258	26,444	17,574	44,018
1961	21,101	5,664	26,765	17,106	43,871
1962	21,249	5,848	27,097	16,682	43,779
1963	20,288	4,75[illegible]	25,039	16,347	41,386
1964	20,620	4,855	25,475	17,488	42,963
1965	18,761	4,724	23,485	16,025	39,510
1966	16,076	4,191	20,267	14,891	35,158
1967	15,203	3,556	18,759	13,538	32,297
1968	14,227	3,385	17,612	12,987	30,599

Source: 1955 through 1966 from Gas Facts, table 31, p. 37; 1967 through 1968 from International Oil Scouts Association yearbooks, pp. 531, 538 (1967); pp. 482, 490 (1968).

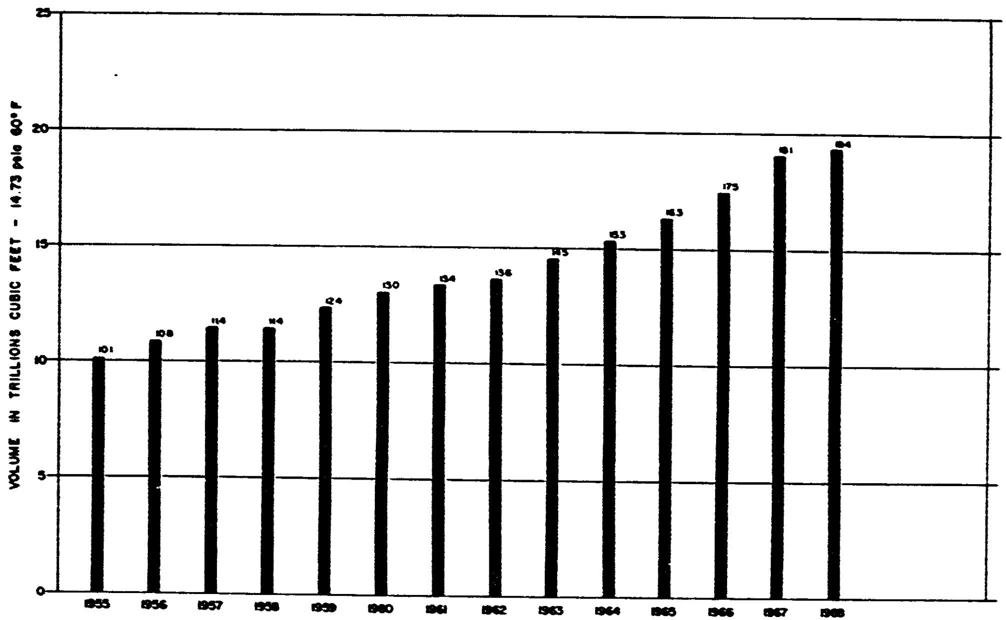

UNITED STATES
Natural Gas Reserves and Net Production History
Reduced To Reserve Life Index
RESERVE LIFE INDEX - YEARS
VOLUMES IN TRILLIONS CUBIC FEET - 14.73 psia 60° F
Reserve Life Index
End of Year Reserves
Gross Additions to Reserves
Annual Production


UNITED STATES
Number of Well Completions
Excluding Service Wells
Shown by Oil Wells-Gas Wells-Dry Holes
1955-1968
NUMBER OF WELLS - THOUSANDS
0
10
20
30
40
50
60
Total Wells
Oil Wells
Gas Wells
Dry Holes
2

4543

UNITED STATES

Annual Natural Gas Production



STATEMENT OF WILLIAM J. MURRAY, JR., TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION

I. The nation is running out of oil and natural gas—not for lack of adequate domestic resources but rather for lack of adequate incentive for domestic exploration and drilling.

—Reserve productive capacity has been grossly overestimated, and some degree of Consumer rationing might prove necessary in any future foreign-supply curtailment.

—There is growing recognition within both industry and government that an energy gap looms just ahead, unless domestic drilling rates are restored at least to former levels.

—"End use controls," a form of consumer rationing, may soon be required for natural gas because of diminishing supply; a new FPC study, revealed by Chairman Nassikas, indicates that the supply of deliverable gas is already down to 10 years, and continuing a sharp decline.

—To attempt to fill the emerging energy gap by increasing imports would not only endanger national security but would thwart all efforts to close the nation's payments gap.

—Paradoxically, the proposals before the Committee, labeled tax reform, would further depress domestic exploration and drilling at the very time when an increase is required to avert a supply crisis.

II. The expensing of non-recoverable costs is absolutely vital to the domestic wildcatter, and to require that these costs be capitalized would render it impossible for most small operators to look for oil and gas.

—The independent producer is not trying to escape his fair share of the nation's tax burden; he is quite willing to pay taxes on oil and gas produced and sold, but cannot be expected to drill for oil if denied the privilege of expensing intangibles.

—The intangible charge-off privilege does not allow the producer to retain or pocket one cent of his income, but rather serves to encourage him to go into debt or seek outside risk capital in order to remain in the business of searching for reserves to produce.

—Denying the intangible expensing privilege would be particularly injurious to independents trying to get started, while having relatively far less effect upon the large integrated companies and larger independent producers.

III. The 27.5 percent factor is supportable on numerous bases. Fundamentally, if the rate were too high, there would be disproportionate concentration of resources into this enterprise, when the contrary is true.

IV. The 50 percent of net limitation works a particular hardship upon the smaller operator and upon the caretakers of the nation's marginal or stripper wells so essential to America's relative self-sufficiency in energy resources.

—Because of the 50 percent of net limitation, few domestic independent producers enjoy anything approaching the full 27.5 percent depletion.

—An increase in the net limitation would enable all operators to realize a more nearly uniform depletion percentage factor and serve to encourage domestic independents to become more active in the search for oil.

V. Particularly injurious to independents would be the proposal to require individual producers and outside investors who derive less than 60 percent of their income from oil and gas operations to include intangible expensing and depletion income in computing their tax liability.

—The LTP plan, while excluding large corporations, seems aimed directly at the independent producers, upon whom the nation historically has relied for 75 percent of domestic discoveries.

—It is the independent who is aggressively searching for oil and spending every cent he takes in and can borrow who would be the principal victim of the LTP provision.

VI. The mineral interest holder, or land and royalty owners, more than a half million in number, would be particularly effected by the LTP and percentage reduction proposals.

—Proposals denying land and royalty owners full participation in depletion would undermine the foundation upon which America has built her great energy industry, and would further depress domestic exploration and drilling by denying a primary investment stimulus to this nation's drilling efforts.

VII. Elimination of the ABC method of financing development, elimination of carved-out production payments, and the proposed recapture rule that would require treating as ordinary income any gain or sale of mineral properties to the extent of intangible drilling costs previously deducted, all would hit hardest at the domestic wildcatter.

VIII. The time is at hand to increase, not decrease, incentives to domestic independent oil and gas producers, if we are to avoid a dangerous energy gap.

—Any increase in the tax burden upon the domestic producing segment of the petroleum industry will result either in curtailed drilling or an increase in consumer prices.

STATEMENT

Mr. Chairman and Members of the Committee; my name is William J. Murray, Jr., and I am President of the Texas Independent Producers and Royalty Owners Association. Our membership approximate 3,500 independents who have oil or gas operations in the State of Texas.

TIPRO welcomes this review of oil tax policy, recognizing that the extremely serious problem of inadequate domestic oil and gas supply to meet projected needs must be the central consideration in governmental deliberation of the oil tax program. Independent producers and royalty owners across the nation share a deep concern over the failure of national oil policy to ensure adequate search for domestic reserves.

In considering tax reform proposals as they affect the domestic oil and gas producer, there is first the need for a realistic appraisal of the actual condition of the domestic petroleum industry today.

Bluntly speaking, the nation is running out of oil and natural gas—not for lack of adequate domestic resources but rather for lack of adequate incentive for domestic exploration and drilling.

There are some who realize that this is true but fear that such a statement will harm the industry and worsen the already-alarming situation. Others fail to speak out because of vast undeveloped reserves of petroleum both on land and offshore, tremendous quantities of secondary recovery oil which may become available, and potential liquid hydrocarbons which can be produced from oil shale. However great our potential, the hard-boiled statistical fact is that these potentials are not being realized.

The U.S. has grossly inadequate proved recoverable reserves of oil and natural gas to meet the increased demands of the future. Annual additions to reserves are less than consumption; and the method of reporting reserves probably obscures an even darker picture.

This Committee is surely aware of the importance of surplus domestic producing capacity to national security and to a dependable consumer supply. In view of this, it is important to realize capacity has been unintentionally but almost always overstated in the past, and in my opinion is being overstated today—to the extent that surplus capacity is almost non-existent.

All of the states in this nation, other than Texas and Louisiana, are admittedly producing at capacity. Texas and Louisiana do have some fields that could produce more than they are currently producing but they also have hundreds of fields that cannot long efficiently sustain their current rates. It is probable that the natural decline both in efficiency and in actual productive capacity of these older fields will about offset the remaining efficient surplus capacity of a few other fields. (Even the most conservative estimates indicate that by 1972 Texas, for example, will have run out of surplus producing capacity.)

According to Texas Railroad Commission reports during the first half of 1969, Texas underproduced its oil allowable by nearly 520,000 barrels authorized during the past five years. In 1969, the State produced one-third less than it did in 1965 per producing day authorized. For Texas—the state which produced more than two-thirds of all the oil used by the nation's military during World War II and which largely met the sudden needs occasioned by the Korean conflict and the various Mideast crises—to now be so underproducing its allowable in a relatively normal period is a very sobering fact.

The situation regarding natural gas is fully as bad—probably worse when it is realized that it is technically difficult and economically unsound to import natural gas from overseas. The reported situation on proved reserves and discovery rates in themselves reveal inadequate supplies to meet future increased demand. But these reserve estimates, like estimates of oil producing capacity, are based on out-of-date studies and are understandably but dangerously optimistic.

Only in recent days the new chairman of the Federal Power Commission, John Nassikas, revealed that a staff study now nearing completion indicates a 10 year supply of deliverable gas. This finding, coupled with available government and industry information, clearly constitutes a warning that unless present trends are reversed soon this nation will face a critical gas supply problem.

We say to you without fear of contradiction that all responsible studies in recent months have concluded that we face a critical oil and gas supply problem—a domestic energy gap, so to speak. Further, we charge that this energy gap is wholly unnecessary, the result entirely of the denial of adequate incentives for domestic exploration and development. For a great many reasons, our nation cannot and must not tolerate this situation.

At stake not only is consumer discomfort. If rationing of our prime energy resources were the only danger, maybe that would be tolerable. The day we become helplessly dependent upon foreign energy sources, not only will the American consumer be gouged mercilessly in the price he pays but may quite easily find himself denied adequate energy at any price. Quite obviously, this situation would threaten our survival in a hostile world. Our national security and our economic stability are very much imperiled by the present trend.

This, then, is hardly the time to be talking about proposals which would further curtail home exploration and drilling. Yet that is precisely what is before us in the guise of tax reform.

Role of the independent explorer

Unquestionably, the most important factor behind the nation's petroleum supply crisis is the decline in independent producer activity. Historically, the independent has been responsible for more than 75 percent of the nation's exploration for domestic oil reserves. It is he who in the past has been willing to assume the substantial risk of drilling wildcat wells.

Since the mid-1950's, however, declining economic incentive has cut the independent's well drilling activity by more than half. This is reflected in the attached chart which shows the sharp decline in the number of wells drilled annually in the nation's largest producing state, Texas. A total of 18,526 wells were drilled in 1950, while a total of only 8,750 is anticipated for 1969, a drop of 52.8 percent.

While the growing demand-supply squeeze has alleviated one of the independent's former economic problems—severely restricted opportunity to produce—several others remain to assure inadequate exploration and development activity on his part. Among them are: an inadequate price for domestic crude oil that still remains below decade-ago levels; sharply increasing costs, which continue to rise in the extended inflationary era now being experienced; ineffective oil import regulation which not only failed to restrict import growth in reasonable proportion to domestic production but also apportioned import quota privileges in a manner which served special interests without due regard for the objective of ensuring adequate domestic exploration and drilling; a steady increase in state and local tax burdens; seriously inadequate natural gas prices depressed by an unrealistic area pricing policy administered by the Federal Power Commission; and federal economic policies which have discouraged outside investment in drilling activity. These drilling-incentve depressants virtually guarantee inadequate home drilling in the critical decade ahead, even without the tax proposals currently being aimed at the independent.

There is growing awareness in the Federal Government that a supply crisis exists and that something must be done to assure an adequate domestic drilling program. Yet, paradoxically, serious consideration is now being given by both the Administration and Congress to tax proposals which would further reduce drilling incentives for domestic independent producers in particular.

Current and proposed tax provisions

To emphasize the seriousness of this paradox there is need to discuss current tax provisions and the way in which a typically small but aggressive independent producer operates.

Expensing of Non-Recoverable Costs.—First and most important to the independent is the right to expense the non-recoverable costs. These, usually referred to as "intangibles," include the cost of drilling the hole, the cost of mud, cement and chemicals used in drilling and the cost of various services such as electric logging, gun perforating, acidizing or fracing. Tangibles includes casing, tubing, rods, underground pump equipment, surface pump jacks and motors, stock tanks, separator heater treaters and all other surface equipment. Under the present tax law all operators must capitalize their tangible costs but have the option of either capitalizing or expensing the intangibles. It is my understanding that most oil producers currently elect to expense intangibles. However, it has been suggested that the large corporations who are reasonably certain of continuous income for the next ten or more years would not be seriously penalized by the requirement that intangible costs be capitalized and depreciated over a ten-year or longer period.

On the other hand, capitalization of intangibles would so adversely affect the independent explorer and producer as to cause almost complete cessation on his part of further exploration and development expenditures. This we contend would be extremely harmful to the national welfare.

Furthermore, the privilege of expensing intangibles cannot be considered a tax loophole because it does not permit retaining tax-free income. Actually, the typical aggressive independent who has been criticized for escaping income tax does so only because he spends his total income on intangibles and dips into capital or more usually borrows an approximately equal amount to pay for the tangible costs.

The ratio of tangible to intangible costs varies, but on the average well are approximately equal. It should be emphasized that statements early attributed to Treasury officials must have resulted from misquotation or misunderstanding because no producer is allowed to charge off the entire cost of a producing well. He is currently permitted to expense only the intangible costs but must capitalize the approximately equal tangible costs.

The privilege of expensing intangibles does allow the aggressive independent to escape taxation for a period of time if he uses all of his income on intangible development costs and goes into debt for an approximately equal amount of tangible costs. But during this period when he "escapes" taxes there are no loopholes involved, because he is actually keeping no money—but rather he is continuously going deeper into debt. The incentive for doing this is the anticipation that some day he will be able to enjoy the fruits of his occasionally-successful ventures, either by statutory depletion or by capital gains sales. These incentives must be retained. The immediate point is that intangible expensing can not correctly be described as a loophole but rather a very important tax option if domestic exploration and development are not to be severely retarded.

This is particularly important to young men or young companies who are trying to get started in the oil business. Intangible expensing is vital to them and the proposed "60 percent of income from oil" requirement would never allow them to get started. In effect, it would give a monopoly to existing oil companies and no opportunity for newcomers.

27.5 Percent Depletion Allowance.—We firmly agree with the other industry witnesses who have presented to this Committee sound arguments supporting the economic justification of at least the current percentage depletion allowance. There remains the basic fact that percentage depletion is an incentive to drill in a high-risk industry. Unfortunately the odds are against those who will explore for petroleum in the United States. But the fact that some do hit and because of depletion can keep a significant portion of their income encourages a great many others to continue year after year to invest more in exploration than they ever receive.

The logic of the 27.5 percent factor is supportable on numerous bases. For one think, if it were too high, as some charge, there would be disproportionate concentration of resources into this enterprise. The opposite is true, quite obviously, today. But in terms of the objective of avoiding taxes upon that portion of gross income which represents a return of capital, it can likewise be more than justified. A test of the formula to see whether 27.5 is indeed too high can be conducted simply by asking whether the depletion rate times the gross selling price of a unit of production equals the price at which a similar unit of production can be purchased in the ground. Stated another way, a producer should be entitled to end up the year with the same reserves he started with before he has taxable income.

In the case of oil, assuming the average price at lease tanks of $3.00 per barrel, when 27.5 percent is taken, a producer deducts 82.5 cents from his net income.

But he currently must pay $1 to $1.25 per barrel for reserves to replace the barrel produced. The point is that a producer should have a depletion rate which will give him enough money tax free to replace that year's production by buying reserves. He may of course decide instead to gamble that he can replace them more cheaply by finding them himself and this is his decision and his risk. If a producer can take only 82.5 cents tax free out of a barrel of oil, he is much more inclined to sell his reserves for $1.25 per barrel than if his depletion is $1.25 per barrel. The fact that the 27.5 percent factor is not returning his capital holding accounts for the persistent stream of sellouts with its monopoly implications.

With this in mind, we believe the primary concern of this Committee should be whether or not percentage depletion is performing its intended function both as an incentive to drill and a means of returning capital investment. Since the facts at hand support the contention that the economic and military survival of this country require a greater exploratory effort than is taking place, Congress should be looking for ways to increase rather than retard the incentive for the risk-takers.

The 50 Percent of Net Limitation.—One of the main reasons the current depletion provision has failed to provide adequate incentive is the companion restriction of its application to 50 percent net income. This hits hardest the independent operators are able to enjoy the full 27.5 percent depletion, whereas such may not be the case with international companies. To illustrate how effective the 50 percent net limitation decreases percentage depletion taken by small operators, this Association sampled its membership. Of 70 operators sampled the average depletion taken was only 19.00 percent. One of these, a reasonably typical independent in Texas with a great many years of exploration experience, and a demonstrated capacity as a competent oil finder and producer, has failed to achieve the full 27.5 percent depletion on all but three leases since 1952. Even on these three leases, the full application was short lived in each case.

Internal Revenue studies, we believe, do not properly reflect the true picture for typical independent producers. The examples most often cited are anything but typical, and have almost no relation to the operations of domestic non-integrated independent producers—the nation's wildcatters.

There are several reasons independents are unable to enjoy full depletion. As a rule, they have little or no low-production-cost holdings, more typical of foreign reservoirs, on which attainment of the full rate is normal. Independents are badly hurt by the inflation squeeze on operations, since crude prices have failed to keep pace with higher wages, material and administrative costs of operation, thereby triggering the 50 percent net income limitation. Most independents are "caretakers" of the nation's defense—vital marginal or "stripper" production operations, protecting some 6.8 billion barrels of oil reserves, which reduce net income levels. Finally, few independents are fortunate enough to discover production sufficiently flush to command full depletion after the waiting period during development when percentage depletion does not apply.

It is our position, in short, that present depletion provisions are anything but excessive to the purposes for which percentage depletion was provided, insofar as domestic operations are concerned. To repeat, the 50 percent of net profit limitation serves unnecessarily to prevent its functioning effectively as an incentive to adequate drilling at home.

Other Tax Provisions.—We most strenuously object to the proposal to require individual producers and outside investors who earn less than 60 percent of their income from oil and gas operations to include income derived from application of intangible expensing and percentage depletion in computation of their income tax liability. This would have precisely the same adverse effect on incentive to drill, in principle if not in degree, as the elimination of intangible expensing or reduction in percentage depletion would have. This proposal, commonly referred to as a plank of the Limitation on Tax Preferences plan, would, moreover, be aimed directly at the independent producer as opposed to the major oil corporation.

The independent who is truly aggressive in development is not only spending all of his income but borrowing a substantially equal additional amount. He is building for the future in the hope then that he can develop production on which to pay full taxes. It is this very sort of independent upon whom the nation must depend to do the exploration and development which the country now so desperately needs. It is the independent who is spending every cent he takes in and every cent he can borrow who would be the victim of the LTP provision

The mineral interest owner, the land and royalty owners of this nation, more than a half million in number, would be particularly affected by this and other proposed changes. At stake quite literally may be the foundation upon which America has built its great energy industry. If the land and royalty owners are denied any part of the present depletion provision, the result can only be a further depressant upon domestic exploration and drilling. For it is this source which provides a primary stimulus—in the form of risk capital and encouragement—to the exploration and drilling efforts which have so often proved vital to our national survival.

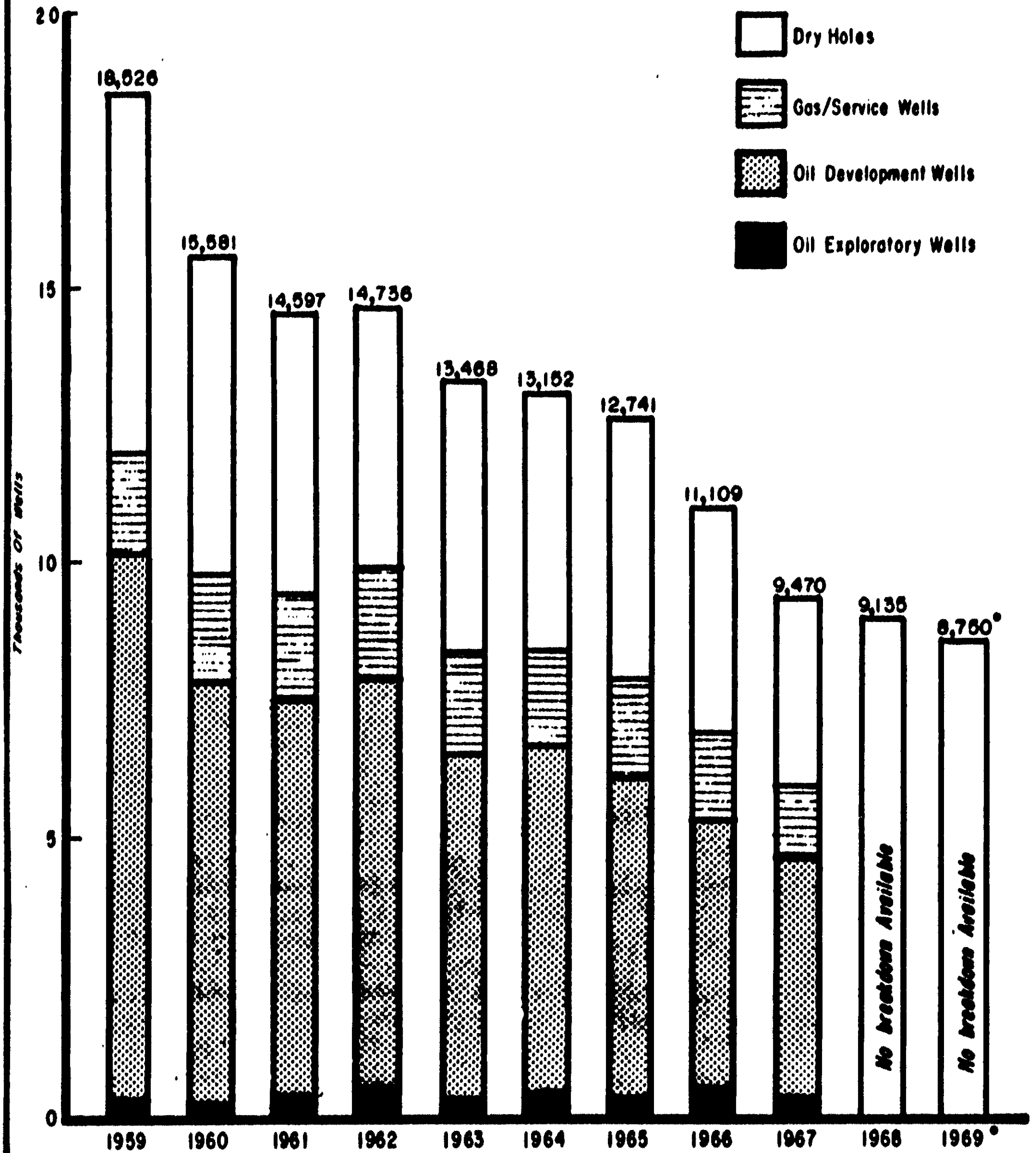
Other proposals either passed already by the House of Representatives or proposed by the Administration which hit hardest at the small independent include elimination of the ABC method of financing development of discoveries, elimination of carved-out production payments, and the proposed recapture rule that would require treating as ordinary income any gain on sale of mineral properties to the extent of intangible drilling costs previously deducted. While independents favor elimination of abuses or inequities under the Internal Revenue Code, they view these current provisions as vital incentives for further exploration. Their elimination or revision would be a devastating economic blow for most independents, necessitating a further sharp curtailment in their drilling programs.

Conclusion

If this Committee concurs in the conclusions that the nation is already facing an energy gap which could soon threaten its very survival, then surely it concurs also that the time is at hand to devise means of revitalizing the domestic producing industry. The future of the industry will literally be determined by what government oil policy emerges in the next few months. Time is about to run out for a relatively self-sufficient energy industry in this nation under present policy. If it is agreed this is vital, then incentives must be improved, not lesssened, for the domestic oil and gas producing segment of the industry. If the proper changes are not made, then investments will increasingly be channeled abroad, with consequent impairment of the domestic industry—and with dire consequences to the nation's security and payments balance.

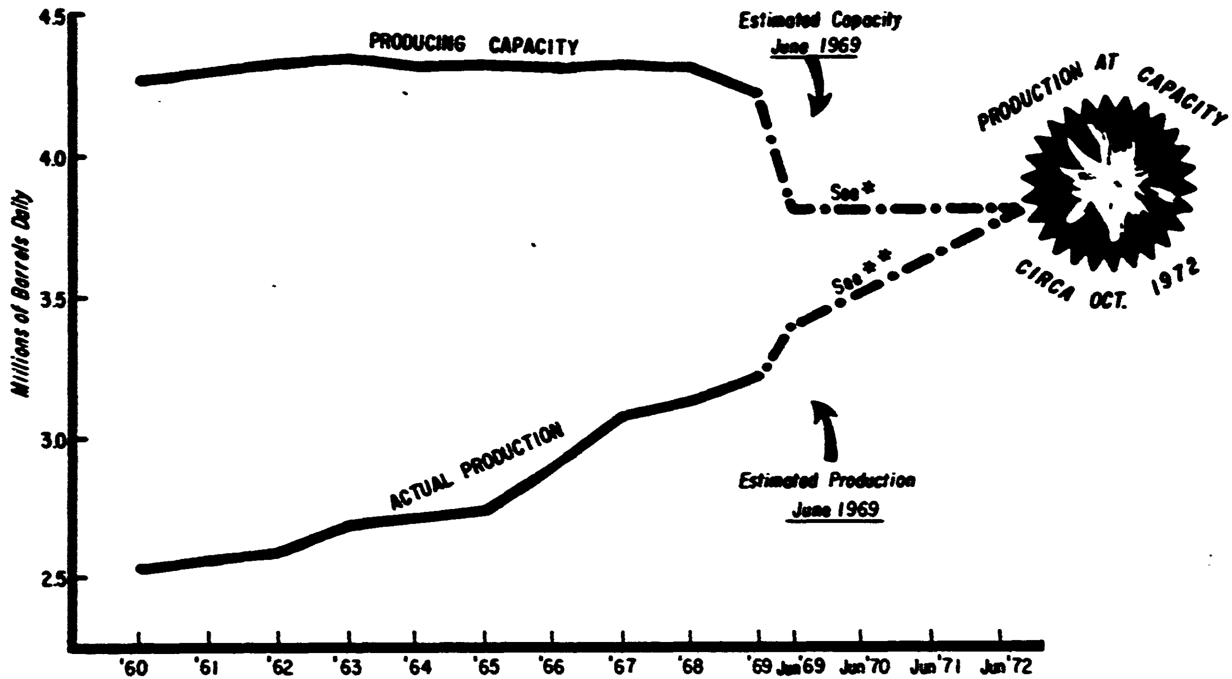
It seems not improper or presumptuous under these circumstances, to say frankly that responsibility for what happens should be clearly assumed by those in a policy-making position of government. If this Committee does not want this nation helplessly dependent upon foreign sources for its energy resources, then any changes in federal taxation of the domestic oil and gas producing industry should be in the direction of increasing incentives for the domestic independent producing segment of the industry.

TRENDS IN TEXAS WELL DRILLING DURING 1959-69 DECADE



* Projected.

ACTUAL AND PROJECTED COMPARISON BETWEEN TEXAS OIL PRODUCTION AND PRODUCTIVE CAPACITY: 1960 - 1972



* Experts close to the situation estimate maximum capacity of 3.8 million barrels daily now and for the foreseeable future, assuming little improvement in drilling rates, upward revision of field MERS and allowable limits where feasible, and continued secondary recovery activity at current levels.

** Assuming an annual growth rate in demand for Texas crude of 3.5%. May be higher due to lack of surplus capacity in other states between now and 1972.

4552

Statement of A. V. Jones, Jr., President, West Central Texas Oil & Gas Association, Abilene, Tex.

SUMMARY

Recommending:

1. The petroleum industry serves the consuming public and serves it well.
2. Petroleum exploration must be increased and since it is risky all costs should be deductible when incurred.
3. Rules on statutory depletion and production payments should be retained.
4. The limit on tax preference (LTP) is directed exclusively towards the small businessman and it will destroy him. If this provision becomes law, it will foster a major company monopoly in the petroleum industry.
5. Recommendation that the present oil and gas tax structure be left unchanged.

Mr. Chairman and members of the committee, my name is A. V. Jones, Jr. I am an independent oil and gas producer and live in Albany, Texas. I appear here today as president of the West Central Texas Oil and Gas Association and am representing the members who belong to this association and also as an individual small businessman widely experienced in oil exploration and development.

I appreciate the priviledge of being allowed to appear here today before the Senate's Committee on Finance because the tax proposals you are considering are of grave concern to me individually, the members of my association, and all who participate with us financially, also vitally concerned are the hundreds of thousands of people in all of 32 oil and gas producing States who are directly involved in the domestic petroleum industry

The consuming public, all the people of this Nation, has been well served by the petroleum industry. Few industries have supplied the consuming public with continually improving products at essentially the same real price. Any adverse legislation will directly affect all consumers.

To supply the energy needs of this Nation, most governmental and industry reports emphasize the fact that petroleum exploration must be increased substantially over the next few years. Historically the independent segment of the petroleum industry explored for and found most of the domestic production. In order to continue the necessary domestic exploratory effort, the cost of exploration and drilling—known as intangibles—must continue to be recognized as essential business expense for all participants in the oil and gas industry. There must be no 50% or any other limitation—all costs should be deductible when they are incurred.

Petroleum exploration is a very risky enterprise and correspondingly there must be *substantial profits* to balance the *extensive* losses. The public hears about the few winners—but never hears about the large number of losers. These losers are a necessary part of the industry. Some make it big and some lose—*this business is unavoidably* different from farming or manufacturing or merchandising—it is a high risk operation. Legislative proposals have often questioned the need for deducting intangibles from taxable income. Intangibles are the cost of finding petroleum and drilling wells necessary to produce the oil or gas. They are routine, normal, legitimate costs of doing business. There should be no limitation whatsoever on what can be invested or reinvested in the business of oil and gas exploration to provide for our Nation's needs.

Statutory percentage depletion has been widely misunderstood. When oil and gas are sold the receipts are partly capital and partly income. Our national tax policy has always recognized that the sale of a capitol asset should be given special treatment. This accounts for the fact that more than 100 mineral products are subject to a depletion allowance and rightly so. Currently percentage depletion is limited to 50% of net income. Due to the extreme risks of the petroleum industry, however, this limitation should be raised to 75% or more.

Production payments and their uses have been the source of considerable confusion. It is our belief that present tax treatment of both ABC and carveout type oil and gas payments should be continued.

Most of the currently proposed oil industry tax reforms are directed against the small businessman engaged in oil exploration and development. To be specific, the so-called limit on tax preferences (LTP) is applicable only to *individuals, partnerships, trusts and small corporations.* This is a punitive proposal, which if it becomes tax law will practically wipe out the independent segment of the industry when the need for our efforts has never been greater. Not only will this so-called limit on tax preferences (LTP) provision wipe out the independents in oil and gas exploration, but *ultimately it will create a major company monopoly by destroying small businessmen.* It does not seem likely that it is the *intent* of tax reform to foster any monopoly, but it will be the *inevitable result* of this limit on tax preferences (LTP) to create just such a major company monopoly in the petroleum industry.

The basic economic facts of fundamental, importance to our industry and national security have become obscured and confused. It appears that the emotional and political aspects of tax reform proposals have shaped them into a discriminatory program—not into a soundly considered piece of tax legislation.

Instead of creating the necessary economic climate for the expansion required, the proposals before you would destroy most of the incentive for petroleum exploration.

Gentlemen, it is my recommendation that the tax structure of the domestic petroleum industry be left unchanged.

The CHAIRMAN. Now we will hear another witness who has to leave town shortly.

Mr. Eberhard P. Deutsch, speaking for the Permian Basin Independent Petroleum Producers Association.

I am very happy to call Mr. Deutsch, a very dear and old friend of mine for a number of years and one of the great lawyers of our country. Mr. Deutsch is responsible for Austria being a free country today. I say that in all seriousness.

STATEMENT OF EBERHARD P. DEUTSCH, REPRESENTING THE PERMIAN BASIN INDEPENDENT PETROLEUM PRODUCERS ASSOCIATION; ACCOMPANIED BY FORD CHAPMAN, PRESIDENT, PERMIAN BASIN PETROLEUM ASSOCIATION

Mr. DEUTSCH. Thank you very much, Mr. Chairman. I can imagine no greater compliment than one coming from you; along with 100 percent of the other electorate of Louisiana, we regard you in that light.

Mr. Chairman, I am speaking here in behalf of the Permian Basin Petroleum Association composed actually of some 3,000 members. In my original written statement I said there were 650 members. That was an error.

Sitting at my right is Mr. Ford Chapman, the president of that association.

I am going to address myself very briefly to one phase of this matter which I have not heard discussed and have not seen treated in the hearings which you have had up to this point.

Of course, the Permian association actually feels the same way as the other independent producers who have expressed themselves here today; that is, they have the same reaction toward the depletion allowance and so on. I am speaking to this subject now because exploration has become so much more expensive through deeper drilling and other factors, and so much of it being done by wildcat independent producers, that they have had to finance themselves through what is known as carve-out production payments.

This subject, so far as I know, has not yet been touched on in this hearing, and I think I can handle it very briefly. A carve-out production payment is merely a sale of perhaps a reservation of, in some cases, a part of a future production of a mineral property. Those payments have had the large tax advantages primarily through the depletion allowance, and they have been recognized just about as long as the depletion allowance has, close to 40 years.

Now, the point that I want to get across is that the independent producers are going to have a frightful time living as such at all if they cannot continue to have the privilege of financing themselves through their producing properties with this carve-out payment system.

The first point I make therefore is that this system should not be abrogated as is proposed in the House bill. If, in the last analysis, the fate of the Nation or the imperative transcendant needs of the Nation demand that that change be made, and I would disagree with that, but, if you gentlemen in your wisdom find that to be the case, at least the retroactive provision of the proposed bill, discontinuing such payments retroactively should not be permitted to stand as is presently written.

Of course, if ultimately the carve-out production payments system is eliminated, with the tax advantage which has accompanied it up to this time, they are not all going to fold up their tents and crawl away. An effort will be made somehow to continue their business. They are American. They are all good Americans, and they still make every effort with the private enterprise system, the capitalistic system, to continue to work out somehow, even with those difficulties, to finance their exploration and development programs.

I think it must be borne in mind, and it is really a simple proposition, that these carve-outs, with which I assume you are familiar, have to be worked out in advance. It takes 2 to 3 years to make appropriate commitments of land leases. A buyer must be found. Geophysical work has to be done to determine how much income will be available to repay a production payment. A drilling contractor has to be found in advance, and so on, in order that equipment may be available when the time comes.

A production payment made in the fall generally has been arranged at least in the spring. It takes months and months, sometimes even a year or so to work that out. Unless that system is continued in effect, and certainly unless it is not permitted to have retroactive effect as now written many of these people will not even be able to repay their present loans that they have contracted on the faith of those provisions of the present loan. They may not be able to honor their contracts. They may not even be able to pay their current drilling bills, and certainly those that are well enough off to take care of their current needs will be unable to take care of any future years, that is starting with 1970, under any circumstances.

Some day perhaps prices will increase, but we cannot help but feel that the independent producers should not raise his capital through price increases which ultimately find their way to the consumer in an inflationary cycle.

Now, we simply submit that the rules of the game should not be changed after play has started, and especially after the second half has been entered as it has at this time. We submit that the tax treatment of carve-out payments under the present depletion allowance should be permitted to stand, but if that simply cannot be done under the paramount needs of the United States of America, then at least it should not be done retroactively and clearly unfairly to these independent producers.

The CHAIRMAN. The so-called carve-out is a way of financing the sale of oil and gas, is it not?

Mr. DEUTSCH. It is the actual sale of oil and gas. If I own a piece of producing property, I sell a part of it to somebody and then it is paid back out of that production, and when the payment has been made in full it reverts to me. It is simply a method of financing exploration used primarily by the independent groups.

The CHAIRMAN. And if this carve-out method of doing business is to be taxed, I suppose it would not be practical to use that method of financing?

Mr. DEUTSCH. It would be impossible.

The CHAIRMAN. Am I right in assuming that this would not present any particular problem to a major company, but that it would present some very serious problems to quite a few independents?

Mr. DEUTSCH. I think that is an eminently fair way to put it. Some of the major companies use carve-outs, but I think they can probably get along without them. They have better credit facilities. They have adequate backing for their financing needs through the banks. The chap from the First National City Bank, for instance, is going to look after the majors all right. But the independents simply do not have that type of situation, and this would be a frightful blow to them.

The CHAIRMAN. Chase-Manhattan can find some money for Standard and First City can find some money for some of the others, Melon Bank can find some money for Gulf. But these independents need something like this, as I understand it, in order to finance further exploration, to sell some of what they have so they can go out and try to find something else?

Mr. DEUTSCH. I would say that many of them will be put out of business if this is not permitted, if they are not permitted to finance in that way.

Senator HANSEN. Mr. Chairman, just let me take this opportunity to compliment your distinguished friend the attorney from New Orleans on his testimony. He has certainly spoken very well the case for independents in Wyoming. They too find just as you have found, the extreme importance of this type of financing in order to carry on an exploratory program, and I hope that everybody in this country, before these sessions are concluded, may better understand that fact.

Mr. DEUTSCH. Thank you very much, Senator. I was not really testifying solely for the Texas, the west Texas producers, but for all of them, of course, including those in Wyoming and in other States.

The CHAIRMAN. Thank you very much.

Mr. DEUTSCH. Thank you very much. I would like, Mr. Chairman, if I may, if it is appropriate, to put into the record an interesting cartoon which appeared on this subject in the New Orleans States-Item, the day before yesterday, and I think it is highly illustrative in graphic form of the point I have been trying to make.

(The cartoon and Mr. Deutsch's prepared statement follow:)

'Yes Sir, I Think I'm Gonna Like You!'

STATEMENT BY EBERHARD P. DEUTSCH, NEW ORLEANS, LA.

SUMMARY

1. The independent petroleum producers of the United States oppose any reduction in the present oil-depletion allowance under the income-tax laws, on the ground that this allowance is a vital incentive to stimulate the search for new sources of oil and gas.

2. Exploration and development of oil and gas reserves have grown increasingly expensive in recent years. The independent producer has had to meet these ever-increasing costs, in large measure, from carved-out production payments.

3. The present advantageous tax treatment of such payments was accorded to the petroleum industry to encourage the search for oil and gas, and to stimulate its production.

4. It is accordingly tremendously important, especially to the independent petroleum producer who has limited means at his disposal, that the present tax treatment accorded to carved-out production payments be retained.

5. Drilling budgets for one year are always prepared during the preceding year, and land-lease acquisitions are ordinarily worked out and committeed two or three years in advance; and it is contemplated that carved-out production payments are to bear most of the exploration and development expense in the year in which that work is done.

6. If it is deemed necessary, for reasons beyond the crying needs of the independent oil producer, to discontinue the present tax treatment of carved-out production payments, that should under no circumstances be done retroactively.

7. Such retroactive repeal would deprive the independent producer of venture and short-term operating capital, after he is committed and already in debt, at a time when it is virtually impossible to borrow money, and may well drive him out of business.

8. The rules of the game should not be changed after play has already entered the second half. Carved-out production payments have had special tax treatment for more than thirty years.

9. The present treatment of carved-out production payments should be left undisturbed; but if it must now be changed for supervening reasons, it should at least be permitted to remain in effect for the taxable year in which new legislation is enacted.

STATEMENT

My name is Eberhard P. Deutsch. I am a New Orleans lawyer, and appear here in behalf of the Permian Basin Petroleum Association of Midland, Texas—an association of some 3,000 independent producers of petroleum, and individuals and firms affiliated with them, primarily in West Texas.

The Association opposes strongly any reduction at all in the present oil-depletion percentage allowance under the income tax laws of the United States, which its members submit is necessary to provide adequate incentive to stimulate the search for new sources of oil and gas.

The share of petroleum in the United States energy market has shown a steady growth for many years. The increased demand has been equivalent to an annual average advance of 5.5 per cent since 1920. Demand has increased to such an extent that, today, the Department of the Interior estimates that seventy per cent of the energy consumption in this country is provided by crude oil and natural gas. The oil industry must meet this petroleum demand in the United States. There can be no doubt that greater oil production is imperative to our national security.

From the time that oil was first discovered in commercial quantities in 1859 at Titusville, Pennsylvania, the United States became an explorer of both crude oil and its derivatives. But in 1948 the United States became a net importer. Since then, foreign oils have gradually increased until now some 21.1% of the United States crude oil supply is imported.

The international petroleum industry is today experiencing a supply-demand race for world markets. In 1964, for the first time, production in Middle East fields equalled that of the United States. Because the expense of discovering and developing foreign production has been lower than that for domestic exploration and development, American oil companies are participating increasingly in foreign operations to the detriment of domestic production. To obtain an advantage of $1 per barrel in discovery-production cost below that in the United States, American producers are willing to absorb the high initial costs of establishing foreign production and markets.

Oil and gas is the only depletive-resource industry which spends a major share of its earnings on the finding and development of new reserves. Nearly one-quarter of the industry's gross revenues is spent on exploration alone, most of which fails to locate any oil. Eighty per cent of new wells are development wells, drilled to sustain existing production in order to compensate for the continuous depletion of older wells whose productivity is tapering off.

The domestic petroleum industry has encountered increasing difficulty in locating new crude oil reserves to meet the ever-increasing demand, in spite of a major increase in its effort to find oil. Drillers must bore deeper into the earth than ever before to find new reserves; and this increases their cost, as does also the constantly rising cost of leasing land.

The capital required to finance these increased costs and efforts inevitably strains the industry's capacity to generate such funds; and the small independent producer must obtain this money from carved-out production payments to meet the cost of its drilling program.

A "carved-out production payment" is created by the sale, by the owner of a mineral property, of a portion, but not all, of the future production attributable to his property. A "reserved production payment" comes into being, by the mineral-property owner's reservation to himself, of a portion of the future production attributable to his property, and his sale of the remainder to another person.

The money received by the seller of the carved-out production payment is generally classified as ordinary income subject to depletion during the year in which it is received. The money received by the owner of the retained production payment is subject to percentage depletion during the payout period.

That portion of the production income, in either a retained or carved-out production payment situation, used to pay off the amount of the production payment, is excluded from the income of the mineral-property owner during the payout period. Any money received by the mineral-property owner, not applied to the production payment, constitutes ordinary income to such owner, subject to cost or percentage depletion depending on his cost basis for the mineral property.

In a carved-out-production-payment situation, expenses attributable to producing the minerals subject to the production payment are deductible during the year in which they are incurred.

The present advantageous tax treatment of carved-out production payments was accorded to the oil industry more than thirty years ago to encourage the search for oil and gas, and to stimulate the increased production thereof.

Oil companies, both large and small, prepare their drilling budgets about six months in advance of the beginning of their fiscal years. The drilling program is planned: so many wildcat wells, so many development wells, so much geophysical work and so many leases to buy. Contracts are made in advance with drilling contractors, so that when the time comes for a well to be drilled, a rig is available. The current year's budget was accordingly prepared during the preceding year, and in the case of the small independents, cost is almost always tied to monies received from, and the tax treatment afforded, production payments.

As stated, independent oil producers normally make extensive use of short-term debt capital, from loans which are usually secured by all, or substantially all, of their producing properties. They have access to only very limited amounts of additional borrowing. To implement the financing of their operations, the independent producers have had to rely heavily on various types of sharing arrangements.

Short-term operating credit can literally disappear overnight as a result of some change in the industry's economic environment. The over-all effect of even a minor change in a long-standing oil-tax provision will seriously limit, if not take away entirely, a small producer's short-term fund raising ability. Because of the risks inherent in this activity, exploration cannot ordinarily be financed directly with normal loan proceeds, unless the loans are secured by other assets.

As any wise investor will attest, it is the height of business folly to finance exploration for mineral resources with funds borrowed in the ordinary course. An operator who borrows money for use in exploration runs the double risk of losing the funds in unrewarding ventures, and the possible loss of his producing properties, through foreclosure or by forced liquidation to retire debt.

In addition, the petroleum industry must remain competitive in the capital market, particularly in times of rapid economic growth, and, as now, during periods of tight money.

For the reasons stated, the Congress is urged to retain the present tax treatment of carved-out oil and gas production payments. If, however, it is found to be imperative, for reasons beyond the crying needs of the independent oil producer, to discontinue that tax treatment of such payments, the members of the Association for whom I speak will make every effort to work out, for the future, some new practicable means, through possible long-term financing, of carrying on their exploratory operations.

But, in that unhappy event, they request that their present methods be not cut off retroactively as proposed in H.R. 13270, already passed by the House of Representatives.

Any adverse change, without time to prepare for such change, would immediately affect the collateral securing existing loans, and would drastically restrict the ability of the independent producers to finance their operations with the proceeds of new loans until some new means of fund-raising can be worked out.

It should be emphasized that a sale of a carved-out production payment is not consummated overnight. In the first place, land-lease commitments must normally be made at least two to three years in advance. Months of preparation are spent thereafter finding a buyer for a carved-out production payment on producing property, arranging the financing, gathering the necessary geological and engineering data as a basis on which to evaluate the oil and/or gas in place, and to predict the income. One can be sure that almost every sale of a production payment made in the Fall was initiated in the Spring.

A large percentage of wildcat drilling is done by the smaller independent producers. No banker will finance wildcat drilling ventures without substantial collateral. The money to stay in business must come from discoveries already made. Retroactive repeal of the present tax treatment of production payments, added to the financial problems which the independent producer already faces, will deprive him of the availability of venture and short-term operating capital, and may well drive him out of business.

Unless the effective date of the proposed legislation is postponed until the end of the taxable year in which the legislation is enacted, many small oil companies will be unable to meet their short-term bank loans, to honor their contracts, or even to pay for their current year's drilling programs; or, at best, they will be unable to drill any wells at all during the following year; all because funds allocated for such costs will not be forthcoming.

Another reason for giving the industry time to adjust to a sudden change in its tax treatment, is to preserve its right to sell an oil payment for income to offset a loss carry-forward. Suppose that a company, which may have had a loss five years ago, has attempted unsuccessfully to earn profits in the course of its normal business transactions over the past four years. The company now perforce plans to sell a production payment to make up its loss. Making the effective date of the proposed change in the production-payment tax allowance retroactive, would penalize the company which had endeavored to avoid selling a production payment in prior years in the futile hope of other profits which had failed to materialize. There should be no difference between this situation, and that of a company in any other industry which sells assets at a profit to offset a loss carry-forward.

If the carved-out-production-payment tax treatment is taken away retroactively on the effective date proposed by the House of Representatives, it will leave an important segment of the oil industry without capital at a time when it is virtually impossible to borrow money, whereas, if the effective date is deferred until the end of the taxable year of enactment, the independent can at least try to devise some other means—however difficult he may find that to be—to meet his expected financial needs.

No company—and especially no independent oil producer—can operate without capital. If one source of exploratory and development capital is abrogated retroactively, and without adequate time to endeavor to arrange other sources, the industry may be driven to the wall. If it can find no other source of funds, it may well have to look to the consumer for finances in the form of higher prices. Concededly, it is not sound economics to raise capital by raising prices in an inflationary cycle; but if there is no other plan, that becomes the only way.

It is respectfully submitted that the rules of the game should not be changed after play has started, and has, in fact, entered its secon half. As stated at the outset, the members of the Permian Basin Petroleum Association, whom it is my privilege to represent before you, will make every effort if they must, to find new ways and means to finance their future exploratory programs in place of the production-payment method which has heretofore worked so well for all concerned.

They urge, however, that the present method be permitted to stand; but if, for reasons beyond their own imperative needs, this system, which has been in effect for more than thirty years, must now be abandoned, they earnestly request that the present tax treatment of carved-out production payments be permitted at least to remain effective for the whole of the taxable year in which the new legislation is enacted.

The CHAIRMAN. We will be back here at 2 o'clock to take the testimony of the remaining witnesses. I regret we have not been able to hear all the witnesses in this morning's session.

(Whereupon, at 1:05 p.m., the committee recessed, to reconvene at 2 p.m., on the same day.)

AFTERNOON SESSION

The CHAIRMAN. Ladies and gentlemen, other Senators will be along as the afternoon goes on.

Next, I call Mr. Joseph R. Rensch, president of Pacific Lighting Service Co.

We have your statement, Mr. Rensch. You can proceed to summarize it.

STATEMENT OF JOSEPH R. RENSCH, PRESIDENT, PACIFIC LIGHTING SERVICE CO.

Mr. RENSCH. Thank you, Mr. Chairman. I am here speaking on behalf of the American Gas Association as well as my company, the Pacific Lighting group of companies. We serve, in southern California, the largest gas distribution system in the country, and we are responsible for gas service to 12 million people in an area that is very heavily dependent on natural gas.

The American Gas Association represents almost all of the public utilities who distribute gas in this country, as well as the pipelines who buy the gas from the producer and sell it to us.

My remarks today are going to be confined to the natural gas situation and the very critical supply outlook that we face at this point, I speak as a distributor in saying that; then, I will talk about the impact of the proposed changes in tax incentives for exploration as they are going to affect our industry and our consumers, and I am talking about 200 million people.

We have a dilemma, Mr. Chairman, in this respect: Our potential supplies are up. As technology advances, as we learn more about the geological structures in our country, our estimates of the gas available to be discovered are increasing, and very much so.

For example, a very important estimate of potential supplies has been doubled just in the last 2 years. But at the same time, the development of proved gas reserves is lagging badly, and, as has been mentioned this morning, we are actually faced with the situation that our proved reserves of natural gas in this country declined last year.

Drilling for gas is lagging for two very basic reasons:

(1) There is a lack of incentive to drill for gas in this country, and (2) there is a lack of capital available to drill; and the two, as you know, are very closely related.

The gas industry is working hard to correct those factors that we can do something about, and that is why we are here today. We can't do anything about the tremendous demand for capital of the oil companies, the tremendous demand for the uses of this very limited capital, such as refinery expenditures, and that sort of thing. We cannot do anything about the tight money situation, which is hitting the oil companies very hard these days with the result that they are turning more and more to the money market, particularly the debt market.

I think most particularly we gas distributors cannot do anything about the fact that the producers are not public utilities, and, therefore, have no obligation to go out and drill for one cubic foot of gas.

We can seek to do everything we can to preserve the incentives to drill, the incentives to explore for gas, the incentives to develop gas.

The percentage depletion provisions in our present tax laws and other tax incentives now available do provide the incentive to explore for gas, and they do provide internally generated funds.

This comes to one of the very important problems we, in the gas industry, have now. This country is becoming more and more dependent on natural gas, because of its effect on the environment—this clean-burning fuel that we have available to help us meet a very critical national problem, and we are now supplying one-third of this Nation's total requirements. Despite the tremendous demand for our product, the gas industry is at the end of the line as far as attracting the producers' drilling dollar. We are at the end of the line.

I can state this another way: Any limitation on exploration dollars available to the major oil companies and the independent producers, hits gas first.

The CHAIRMAN. You might explain that. Why is it that a reduction in depletion allowances will force the housewife to pay more for natural gas and for electricity?

That is what you are saying, as I understand it.

Mr. RENSCH. We are going to still be able to beat electricity, but she is going to have to pay a lot more money if we do cut down the depletion allowance and do reduce the exploration for gas.

The CHAIRMAN. Explain how that would come about.

Mr. RENSCH. All right. This is the way it works, Mr. Chairman. Natural gas in this country is priced on a cost basis. All the gas we buy—and we buy over a trillion cubic feet of gas every year to deliver to our consumers in southern California—is based on cost.

If you take away the depletion allowance and if you take away the other tax incentives available to these producers, that cost then automatically will get in the pipeline company's cost and will automatically come into ours, and we, in turn, will pass it on to our 12 million customers to whom we serve gas. But that is only the start.

At that point, you can say: "All right. All you have done is taken a dollar out of one pocket and put it into the other." But here is the other area of costs imposed on this consumer who has the mistaken impression that he is going to gain something by reducing this depletion allowance. Here are some unnecessary costs that he is going to have to pay, if depletion is reduced and exploration therefore is also reduced.

If we can't get an adequate gas supply developed in this country and we have to back away on our industrial sales of gas which keep our facilities fully utilized—and, remember, we have got $35 billion of facilities around this country, high capital-cost facilities—if we have to reduce the use of those facilities because of the shortage of natural gas, then those continuing high fixed costs of gas have to be imposed on that little household consumer. And I could get very specific on the type of dollar impact, but I will not take your time unless you wish me to dwell on it.

But I can tell you, sir, that we have spent a lot of time on computer studies, showing what happens when we cut down on supply but maintain our facilities at fixed costs, and the person who is going to pick up that bill is this little consumer who thinks he is going to gain something by a reduction in the depletion allowance.

The CHAIRMAN. What you are saying is that when you reduce the depletion allowance, you are raising the tax on the people who are producing natural gas.

Mr. RENSCH. Yes.

The CHAIRMAN. And when you raise the tax on them, they are going to pass it on to you. As a man who is an executive of a utility company, you, in turn, have to pass that on to the housewife.

Mr. RENSCH. That is exactly right, and, then, in addition, Mr. Chairman, we have got to pass more costs on to her. In other words, it is not just a matter of putting dollars out of the gas consumer's pocket into the Treasury; it is going to cost that consumer more money, because we are going to have idling of facilities, which is an unnecessary cost that is also going to come out of the consumer's pocketbook. Another thing that is going to happen to us, Mr. Chairman——

The CHAIRMAN. Let me get that part of it straight. What you are saying, as I understand it, is that when the incentive to drill for oil and gas is less than it is now, you already have a developing shortage of gas at the moment; don't you?

Mr. RENSCH. Yes, we do.

The CHAIRMAN. And so the shortage will get worse because of less incentive to drill for oil and gas, and, as the shortage becomes more pressing, then, you will not be able to fully utilize the plants that you have to use this fuel. And since you can't fully utilize it, the per-unit cost of the electricity and the gas that you are passing on through to the consumer will have to rise because you cannot fully utilize your facilities.

Mr. RENSCH. Exactly. That is exactly what will happen. And in addition to that cost, Senator Long, we are going to have another cost imposed on our consumers, and it is caused by this factor.

We in the gas business are not just about to go out of business just because we are not developing adequate domestic supplies. We are going to get the gas into our system. The two places we are going to turn are imported supplies—and by that I also include Alaska. My company is looking at Alaska right now. We are going to turn to those supplies, and we are also developing, just as fast as we can researchwise, synthetic natural gas.

This is a long-range solution, because synthetic natural gas can be made from our abundant supplies of coal, and we are going to have that gas available.

But that costs more money, and it just does not make a bit of sense to go out and pay 50 percent more for those supplies when we can develop our own domestic natural gas supplies and hold that off.

I mean the consumer is the fellow that is going to have to pay that bill and this consumer is the fellow who thinks he is gaining by the elimination of this depletion allowance.

The CHAIRMAN. Can you tell me how much gas—on a B.t.u. basis—sells below the cost of oil? In other words, if oil is $3 a barrel, let us say in terms of B.t.u's, how does the price of gas compare?

Mr. RENSCH. It varies around the country. If you go up to the New England area, for example, gas can't compete with oil at that price. Now, down in my area we can, and we can beat $3 for oil rather substantially. I think our equivalent price is about $2.10 a barrel.

But more than that, in southern California, Mr. Chairman, the gas is burned whenever it is available because of the air pollution problem we have out there. Any gas we can bring in there, they burn, and that is why Los Angeles has the most efficient air pollution program in terms of control of stationary sources in the country.

It is because we burn tremendous quantities of natural gas and oil is only burned when gas is not available, and coal is not burned at all out there. So, pricewise, we happen to be below oil. Electricity is two and a half times our cost, and we are below the price of oil, and fortunately gas is what they want to burn out there from the standpoint of air pollution; that pressure is intense in the southern California area.

The summary of our position before this committee is that we do have in our industry a temporary gas supply problem that is most critical now. I emphasize the word "now", because, if we do get this thing turned around, by preserving the present tax incentives and a more realistic policy as far as natural gas is concerned, it is still going to take time for us to get natural gas supplies back at the level they should be. We need time before we can get these synthetic supplies and imported supplies in.

I just can't say strongly enough that any reduction in the tax incentive as it affects the drilling for gas could not come at a worse time. Every effort right now should be made toward increasing, not decreasing, the incentive to go out and drill for gas.

Thank you.

The CHAIRMAN. Thank you very much, sir.

STATEMENT OF JOSEPH R. RENSCH ON BEHALF OF THE AMERICAN GAS ASSOCIATION, INC., AND THE PACIFIC LIGHTING SYSTEM

SUMMARY

1. A disturbing paradox exists currently: Estimates of *potential* gas supplies have increased substantially; estimates of *proved* recoverable reserves declined last year.
2. Since 1946, the Nation's gas Reserve/Production ratio has declined from over 32 to less than 15.
3. Additions of new proved reserves are lagging because drilling activity has declined sharply since 1956.
4. At the very time Congress is considering a reduction in the incentives to drill, the temporary supply problem is most critical.

5. The long-term outlook for adequate gas supplies is bright because domestic supplies will be supplemented by imports and synthetic pipeline gas, but maximum domestic supplies must be developed now because there will be a time lag before there supplemental supplies become available in significant volumes.

6. Reduction of the depletion allowance and other tax incentives would impose added and unnecessary costs on the consumer.

   a. An increase in the producers' tax expense would flow through to the consumer.

   b. Shortage of domestic natural gas supplies would hasten the dependence on higher cost imported supplies and synthetic pipeline gas.

   c. If gas supplies should become inadequate to continue service to the load balancing industrial market, the cost of serving the small household consumer will be increased.

7. The current lag in exploration and development of new domestic gas supplies can be attributed basically to lack of available capital and incentive to drill for gas.

8. Reducing tax incentives at this time would further reduce cash available for drilling and would be a severe blow to the gas industry's efforts to develop gas supplies that are available and badly needed now. Such a reduction could not come at a worse time.

Statement

I am President of Pacific Lighting Service Company, headquartered in Los Angeles, California, and I am appearing on behalf of the American Gas Association and the Pacific Lighting System.

THE AMERICAN GAS ASSOCIATION

The American Gas Association is comprised of 271 gas distribution companies, 67 gas and electric distribution companies, 31 gas pipeline companies and several thousand individual members. Over 40 million homes, businesses and industries in this country are served with natural gas; the distribution companies in this Association serve over 90% of these customers.

This Nation has become highly dependent on this clean, efficient and economic source of energy. Over one-third of the country's total energy requirements are now provided by natural gas. This dependency is reflected by the gas industry's $35 billion investment in facilities and many more billions of dollars of consumer investment in appliances and other equipment.

THE PACIFIC LIGHTING SYSTEM

The Pacific Lighting companies serve the country's largest and fastest growing gas distribution system. Our two large distribution companies, Southern California Gas Company and Southern Counties Gas Company, serve approximately 3,100,000 retail customers and wholesale natural gas to supply another 470,000 customers in Southern California. Over 12 million people depend on our companies for a reliable supply of natural gas at a regulated reasonable price. Our gas operations trace back over 100 years and, for over 40 years, Southern Californians have been heavily dependent on natural gas as an energy source.

THE CURRENT NATIONAL GAS SUPPLY OUTLOOK

A disturbing paradox exists currently in the natural gas industry. Estimates of *potential* natural gas supplies—waiting to be searched for, discovered and developed—have been increased substantially due to recognition of new provinces and improved technology. Consumer demand for this clean, economic energy source is climbing sharply. Yet, the finding and development of proved gas reserves are sagging simply because the producers are not devoting the necessary drilling capital in the continental United States.

I have reviewed 36 estimates of *potential* supplies prepared since 1950. During this period, as new provinces were discovered and technological improvements emerged, these estimates of potential supplies have increased substantially. The Potential Gas Committee, which acts under the objective guidance of the Colorado School of Mines and relies on the input of a large number of the most technically qualified people in the industry, increased its estimates of future potential gas reserves from 690 trillion cubic feet in 1967 to 1230 trillion cubic feet in 1969, due primarily to the new provinces in Alaska and the technological developments that permit deeper drilling both onshore and offshore. But all of these potential supplies are of no value to the consumer until they are drilled for and put on production.

Paradoxically, this year the American Gas Association Reserves Committee reported a decline in the Nation's *proved* recoverable gas reserves for the first time since this nationally accepted Committee commenced publishing annual reserve statistics 23 years ago. During the year 1968, 19.4 trillion cubic feet were produced while only 13.8 trillion cubic feet of new gas reserves were added, so that the Nation's proved reserve inventory declined from 292.9 trillion cubic feet to 287.3 trillion.

The chart in Appendix A compares the yearly reserve additions with the net annual production totals since the end of World War II and graphically illustrates the recent disparity between increases in supply and demand for gas. During this period, the Nation's ratio of proved reserves of natural gas to annual production has declined from over 32 to less than 15 by 1968. (See Appendix B) The sharp downward trend in the Nation's Reserve/Production ratio must be arrested by the development of new domestic reserves so that the inventory does not get too low before large scale production of synthetic pipeline gas becomes available.

The tabulations of certain key statistics included in Appendix C demonstrate why the addition of new proved gas reserves is lagging. Total new well drilling reached a peak in 1956 and has been declining ever since. Since that year, the following decreases have been recorded:

Total exploratory wells	down 45%
Gas discoveries	down 48%
All new wells	down 47%
Gas producers	down 26%
Active drilling rigs	down 57%

This tabulation also shows that the total number of producing gas wells has declined in each of the past two years.

Now, at the very time Congress is considering a reduction in the incentives to drill, the industry's temporary supply problem has reached its most critical stage. Many of the gas pipeline companies have been unable to acquire the gas supplies to meet the normal growth requirements of the gas distributors this year. Every effort must be made to turn this situation around and accelerate drilling for gas to higher rates of activity than ever before. Time is of the essence because there is a time lag between the resumption of accelerated drilling activity and the proving up of the gas reserves to deliver to the pipelines.

FUTURE SUPPLIES

The long-term outlook for adequate gas supplies is bright not only because our growing recognition of the large volume of potential supplies and our ability to supplement future supplies with imported volumes (delivered by pipeline or by tanker in the form of liquefied natural gas) but, most important in terms of the next century, because of the outlook for production of synthetic gas from the Nation's abundant supply of coal.

This raises another reason for developing the maximum volumes of gas supply in the continental United States at this time. These important future supplemental supplies will be higher priced. The maximum early development of the lower-cost, domestic natural gas supplies will postpone the blending in of these supplemental sources to the benefit of the consumer's pocketbook. Furthermore, although the gas industry's goal is to attain an annual supplemental gas production rate of 20 trillion cubic feet of synethetic gas by the year 2000, further time is needed for pilot plant and development work and the first large scale production facility cannot be expected to be in service much before the mid-1970's.

To fill this time gap, the current rapid decline in the Nation's gas Reserve/Production ratio must be arrested by giving the producers the maximum immediate incentive and access to funds to accelerate the level of drilling activity. Any elimination of the present tax incentives—which, in turn, are a key source of exploration capital—will severely impair the gas industry's effort to solve the immediate supply problem.

THE COST IMPACT ON THE CONSUMER

The American consumer—feeling the need for tax reform—is under the natural impression that he would be benefited by a reduction of the symbolic depletion allowance and other tax incentives now available to the oil and gas producers. Actually, the consumer will not only bear the cost burden of the additional tax revenue but, in addition, will fall heir to other unnecessary costs if the incentive to explore for gas is further reduced by limitations on the tax incentives.

The price of gas flowing in interstate commerce is regulated on the basis of cost, and it can be assumed that any increase in the producer's tax expense will flow through to the consumer. Unfortunately, the cost impact on the consumer would not stop here. First, as indicated above, the certain adverse impact on exploration for domestic gas supplies would hasten the dependence on higher-cost, imported supplies and synthetic gas. Of even greater importance, if gas supplies are inadequate to continue service to the important load-balancing industrial market, gas pipeline and distribution companies will operate their high capital cost facilities at reduced load factors, and this automatically increases the cost of serving their customers. This unnecessary economic penalty on the small household consumer will result if the producers do not proceed to develop adequate domestic supplies now.

THE RELATIONSHIP OF TAX INCENTIVES TO DRILLING

The current lag in exploration and development of new domestic gas supplies can be attributed basically to lack of available capital and incentive to drill for gas. Both of these factors would be worsened by a reduction in percentage depletion and elimination of other tax incentives.

There are other factors currently dampening exploration activity and the gas industry is working hard on those that are subject to alleviation. Unit drilling costs and average well depths are increasing while exploratory success ratios are declining. Shallow, easy-to-find fields have already been found. Many in the industry feel that past Federal regulatory policies have stifled the incentive to explore for gas.

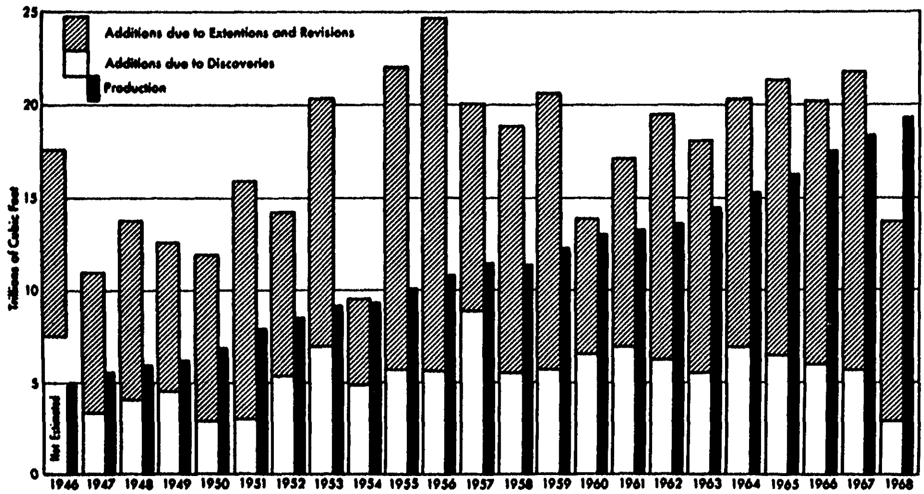
The tight money situation is certainly having its impact. Historically, the producing industry has relied heavily on internally generated funds, but increasing capital requirements have forced much more extensive use of debt capital. And the capital demands on the producers are intensifying further. Recent high bonuses paid for offshore and Alaska North Slope leases have drained exploration budgets. All of these factors combine to make it difficult to attract exploration capital into badly needed domestic gas drilling.

Adding the reduction of tax incentives at this time will decrease the cash which would otherwise be available for exploration and development work and will be a severe blow to our efforts to bring forth the valuable domestic gas supplies that are available to be developed and so badly needed now.

CONCLUSION

The gas industry is seriously concerned that the urgent need of the natural gas consumers has been obscured. It cannot be emphasized strongly enough that any reduction in the tax incentive to drill for gas could not come at a worst time. An all-out effort must be made to increase—not decrease—the incentive to explore for and develop critically needed gas supplies.

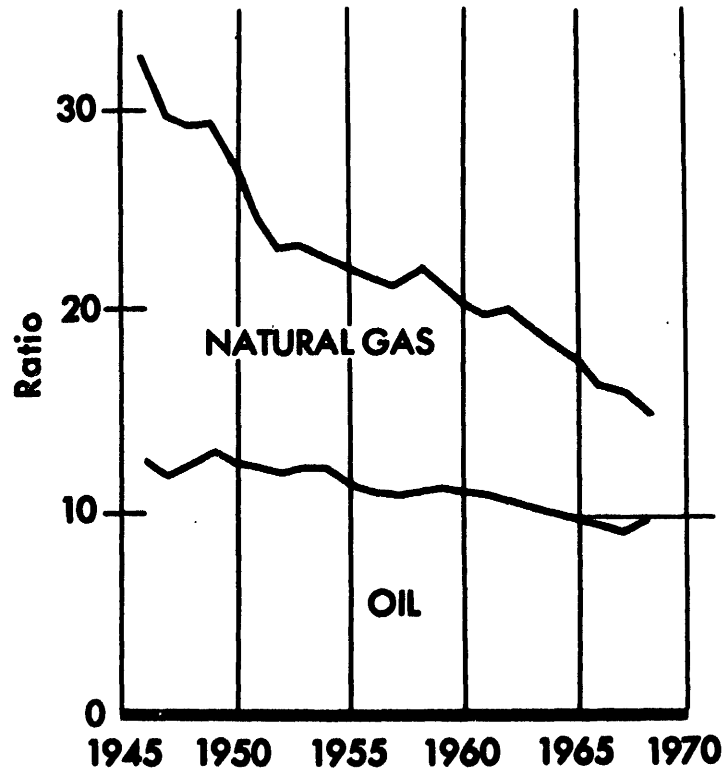
AGA ESTIMATE OF YEARLY ADDITIONS vs. NET PRODUCTION



Appendix A

Appendix B

U. S.
RESERVES/PRODUCTION
RATIO



APPENDIX C

Year	Total exploratory wells drilled during each year [1]			All new wells completed during each year [2]			Total gas [3] wells producing at yearend	Average number of [3] drilling rigs during year
	Total	Discoveries		Total	Producers			
		Oil	Gas		Oil	Gas		
1946	5,759	762	375	30,230	16,087	3,562	62,740	4,353
1947	6,775	982	396	33,147	17,613	3,720	63,676	4,741
1948	8,013	1,098	365	39,477	22,197	3,312	64,212	4,950
1949	9,058	1,406	424	38,962	21,415	3,499	63,346	4,290
1950	10,306	1,583	431	43,307	23,775	3,480	64,900	4,517
1951	11,756	1,763	454	45,996	23,532	3,542	65,100	4,844
1952	12,425	1,776	559	46,509	23,371	3,693	65,450	4,857
1953	13,313	1,981	699	49,480	25,251	4,232	68,223	4,784
1954	13,100	1,985	726	52,197	28,063	4,219	70,192	4,635
1955	14,942	2,236	874	55,879	30,474	4,169	71,475	4,867
1956	16,207	2,267	822	58,418	30,641	4,495	74,261	4,845
1957	14,714	1,845	865	53,783	27,519	4,622	77,041	4,791
1958	13,199	1,745	822	49,101	24,311	5,029	80,400	4,114
1959	13,191	1,702	912	50,179	25,532	4,870	83,225	3,991
1960	11,704	1,321	868	46,831	22,258	5,149	90,761	3,543
1961	10,992	1,157	813	45,644	21,437	5,486	96,809	3,464
1962	10,797	1,211	771	45,997	21,727	5,353	100,267	3,089
1963	10,664	1,314	664	43,126	20,135	4,570	102,966	2,952
1964	10,747	1,219	577	44,149	19,905	4,694	[3] 112,899	3,066
1965	9,466	946	515	40,374	18,065	4,482	[3] 115,834	2,800
1966	10,313	1,030	578	36,883	16,216	4,321	[3] 124,092	2,514
1967	9,059	1,039	556	32,473	15,073	3,602	[3] 121,758	2,208
1968	8,879	863	430	30,939	13,982	3,329	[3] 119,528	2,095

Sources:
[1] American Association of Petroleum Geologists.
[2] World Oil.
[3] Except as noted Bureau of Mines.

The CHAIRMAN. The next witness will be Mr. Walter E. Rogers, president of the Independent Natural Gas Association of America.

Mr. Rogers, we are pleased to have you here as a witness.

We recall the years when you served with great distinction over in the other body, in the House.

STATEMENT OF WALTER E. ROGERS, PRESIDENT, INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA; ACCOMPANIED BY JEROME J. McGRATH, VICE PRESIDENT AND GENERAL COUNSEL, INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA, AND CHRISTOPHER T. BOLAND, MEMBER, LEGAL COMMITTEE, INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA

Mr. ROGERS. Thank you, Mr. Chairman.

The CHAIRMAN. I recall the courteous treatment you gave me before your committee, and I am happy to welcome you before ours.

Mr. ROGERS. Thank you, sir.

I have here with me our vice president and general counsel, and also a legal committee member in our group, who I would like to have at the witness table.

The CHAIRMAN. By all means.

Mr. ROGERS. Mr. Chairman and members of the committee, it is a pleasure to be before this committee to present our views on the tax reform bill. My statement has been filed, as instructed by the chairman, and I will proceed to summarize it.

For the record, I would like to say my name is Walter E. Rogers. I am president of the Independent Natural Gas Association of America which is frequently referred to as INGAA. INGAA is a nonprofit national trade association representing virtually all of the major interstate natural gas transmission companies, subject to the jurisdiction of the Federal Power Commission under the Natural Gas Act of 1938. Our member companies account for over 90 percent of the natural gas transported and sold for resale in interstate commerce. These companies have a total gross transmission, storage and production plant investment of over $15 billion.

Natural gas transmitted through these facilities reaches every State of the Union with the exception of Alaska and Hawaii. The association also includes a substantial group of producers and distributors of natural gas in its membership.

Now, my testimony today, Mr. Chairman, will be directed at two particular features of the tax reform bill. One of these, the first one with which I will treat, will be with reference to accelerated depreciation allowed regulated industries as it applies to the natural gas pipeline industry, and the other will be the matters concerning the depletion allowance.

At the time I requested time to appear before the committee, I asked to be heard on those two subjects, and also on the investment tax credit, but I understand that the committee has already taken care of the latter and that the chairman does not want to hear further on it at this time. So, we will confine our remarks to the two items first mentioned, and I will make this just as brief as possible, and I think we can point it up very quickly.

In 1954, the Congress amended the Internal Revenue Act, section 167, to permit the use by business generally of several types of depreciation. Of course, the straight-line type of depreciation, and then they permitted accelerated depreciation which encompassed several different types of accounting.

Now, subsequent to that time, the regulatory agencies having jurisdiction of regulated industries and the Federal Power Commission in particular, insofar as our industry is concerned, decided that those companies who had the availability of accelerated depreciation must take it and flow it through to their customers.

Now, this is a situation with which these industries are presently faced: If this is done, any tax benefits flowing to the regulated industry must be flowed through to earnings, and this goes on to the customer.

Now, this creates two situations: In the first instance, it deprives the Treasury of much needed revenues.

In the second, it denies to the regulated industry the use of funds that should be available to that industry for investment purposes, as was originally inended when accelerated depreciation was provided.

Now, this has caused several other situations in the regulated industry. For instance, some of the regulatory agencies were not as quick to decide that you must flow through these tax benefits to your customers, so the regulated industries under those agencies simply continued on straight line, and some of the people in our industry continued on straight line.

Others went on to accelerated depreciation, and the ones who did this had to flow through. They were not required by law to flow through, but they were told by these commissions in effect that if they did not flow through, flow through would be imputed to them.

As I pointed out in my written statement, if you tell a man he is going to be snake-bit if he does not move, the chances are he will move, and this is exactly what these companies did.

Now, when the tax reform bill was passed by the House, it froze into these various areas of depreciation each company on the basis they had been conducting their business and using their method of accounting as of July 22, 1969. This simply means that if you were on straight-line, assuming that the House bill is accepted at face value—that if you were on straight-line prior to July 22, 1969, you are frozen on straight-line. If you were on accelerated and you were normalizing, you are allowed to continue that normalization. If you were on flow-through which most of the companies were, you are frozen on flow-through from now on, and there is nothing you can do about it, without the consent of the regulatory agency.

On new property (property acquired after Dec. 31, 1969) a proviso is made for a company on straight-line to go to normalization, that is, to go to accelerated and normalize, but you cannot go on to flow-through. If you are on flow-through on old property, you must stay on flow-through as to new property. So, for all purposes, you are frozen into the flow-through method.

Of course, this is a continuation of the denial of revenues to the Federal treasury, and a continuation of the denial of the tax benefits intended by the Congress to flow to business for investment purposes simply because that is a regulated business.

Now, we have attached to this statement a proposed amendment. We are not wedded to any particular language, but we feel, Mr. Chairman, that a regulated industry ought to have the same treatment as a non-regulated industry.

We feel that, if there are several methods of depreciation provided by the Congress of the United States, the regulated industry should be allowed to use whichever one of those in its best-business judgment will fit its needs; and not be subjected to having these benefits denied because of the ruling of a regulatory agency.

What we have done is this: We would prefer that the industry have complete flexibility in both directions, either to go to flow-through or to go off of flow-through, but realizing the position of the Treasury at this time with regard to the needs for money, we have taken the position in the amendment that we are suggesting so that the industry can go to a slower type of depreciation but not to a faster.

Now, if this is adopted, it simply means this: that the companies will have the opportunity to use these tax benefits, and it will also mean that the Treasury will get more money, more on a short-term basis, and certainly a great deal more on a long-term basis.

If this is not done, it is going to put these companies, which are high-debt-structure companies, very high-debt-structure companies, probably as high as any other industry in the United States with the exception of the housing industry—if this tax benefit is denied to these industries, it simply means this, that they are going to have to go into the money markets and competitively bid for money to meet their needs in the future. If this is done, of course, it is going to contribute constantly to the increase in interest rates.

In my written statement, I said that these interest rates have already gotten above eight and a half percent. It is my understanding that since that time that those interest rates have increased to approximately 9 percent, insofar as the requirements on the company are concerned, because the bonds that they have sold had to be sold at a discount; so, it simply means that their payout is going to require them to produce a little over 9 percent.

Now, whether or not this will be reduced, I do not know. The chances are it is going on up, but we would hope, as an industry, that this committee would see fit to amend this act so that the flexibility that was intended by the Congress when they passed the amendment in 1954 to allow accelerated depreciation so that the members of our industry could avail themselves of the tax benefits—we think that it would serve the country much better; we think that the needed expansion of the interstate pipelines would be served, and we think it would help the general economy all over.

With regard to the depletion allowance, I have listened intently to the presentation of the witnesses this morning, and would simply say that we could endorse practically everything that was said. Our association is unqualifiedly opposed to a reduction in the depletion allowance.

When you look back over the picture, you see that in 1926, if I recall correctly—and, Senator Anderson, I am sure you remember it quite well—the Treasury Department, at that time, suggested above 30 percent as the proper percentage depletion, but, as many things are handled in the Congress, the 27½ percent came out as a compromise, and I think, when we look across the pages of history and see what the oil and gas industry has done for this Nation in comparison with what has been done in other nations, that we ought to try to apply some of the rules that are applied to them to maybe other industries rather than to try to destroy an industry that has contributed as it has, as the oil and gas industry has, to the great achievements of this country.

You may ask and others may ask: "Well, what difference does it make to a pipeline? What difference does it make to an interstate transporter? You are the middleman; you get the gas from the producer, you take it across the country, and you turn it over to the distributor."

Well, you have heard testimony from Mr. Rensch. You have heard testimony from the producers this morning, both the majors and the independents, pointing up the problem.

Our gas supplies are dwindling, and much faster I think than we are anticipating. I was looking at some statistics the other day that our reserves in 1946 measured by years were 32 years. Today, they are about 15. Now, this has been caused by an increasing demand by an expanding population, by new technologies for the use of gas, and, on the other side, you have a dwindling supply. Gas is the lifeblood of the interstate pipeline industry.

Although these projections of the future as to the shortage appear rather bad, I think that there is a possibility that they will be much worse.

I remember, when I first came to Washington, we had some experts that predicted that by 1975 this country would have 200 million people in it. Well, you know we passed that 200 million people in October of

1958. Now, imagine how much they missed their predictions; maybe they wanted to be overly conservative, but 17 years is a bad miss.

I think the same thing could be applied with regard to the energy needs of this country, and I think that one of the best investments that was ever made by the Congress of this country was to provide a 27½-percent depletion allowance and the expensing of intangible drilling costs. Certainly you have the proof of that statement in the great contribution made by the oil and gas industry.

Now, maybe 27½ percent, maybe expensing of intangible drilling costs did not cause it, but I can tell you that it caused a big part of it, because I have spent a lot of my time in the oilfield areas of this country, and I have seen the development and the contribution to the wealth of this country and the contribution to the tax structure, and we would hope that this honorable committee would follow what I think is the splendid record of the past and continuing the 27½-percent depletion allowance, and also the expensing of intangible drilling costs.

Thank you very much.

Senator ANDERSON. Thank you, Mr. Rogers.

(Mr. Rogers' prepared statement follows:)

STATEMENT OF WALTER E. ROGERS, PRESIDENT, INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA

My name is Walter E. Rogers. I am President of the Independent Natural Gas Association of America, which is frequently referred to as INGAA. INGAA is a non-profit national trade association representing virtually all of the major interstate natural gas transmission companies subject to the jurisdiction of the Federal Power Commission under the Natural Gas Act of 1938. Our member companies account for over ninety percent of the natural gas transported and sold for resale in interstate commerce. These companies have a total gross transmission storage and production plant investment of over $15 billion. Natural gas transmitted through these facilities reaches every state of the Union with the exception of Alaska and Hawaii. The Association also includes a substantial group of producers and distributors of natural gas in its membership.

My testimony today will be directed principally to two features of the tax reform bill, both of which are of great concern to our industry. It is the studied opinion of INGAA that if these two features are adopted as presently written in the bill, they could result in serious adverse effect on the industry, the general economy, and the welfare of the nation.

The two features referred to are:

1. Accelerated depreciation allowed regulated industries, and
2. Reduction in the depletion allowance for oil and gas.

These two items will be discussed in the order named.

ACCELERATED DEPRECIATION ALLOWED FOR REGULATED INDUSTRIES

In 1954 the Congress amended Section 167 of the Internal Revenue Code with respect to the depreciation methods and rates available to taxpayers in computing depreciation on tangible property used in trade or business. The taxpayer was given the right by that amendment to elect, from the methods available, to use either straight line depreciation or accelerated depreciation in computing his income tax, and to discontinue its use at any time, both as to new and old property.

The legislative history of the amendment to Section 167 clearly indicates that it was the intent of Congress in providing the depreciation methods described in Section 167(b)(2), (3) and (4) of the Code to allow all taxpayers the free exercise of business judgment in the selection, from among those methods authorized, of the appropriate method of allocating the depreciable cost of property over the years of service, *without restriction by regulatory agencies in the case of taxpayers subject to regulation*. The Code further permits the use of accelerated depreciation for tax purposes and straight line depreciation for book purposes. Normalization is defined generally as the computation of tax expense, for cost of service purposes, by using a method of depreciation which is different from the method actually used for computing Federal income taxes and adjusting a reserve for deferred taxes to reflect the deferral of taxes resulting therefrom.

Despite the clear intent of Congress that regulated industries be permitted the same elections and the same benefits regarding depreciation of their business property as non-regulated taxpayers, several of the regulatory agencies took the position that those regulated companies within their jurisdiction, using accelerated depreciation for tax purposes, would be required to "flow through" currently to the companies' customers any and all tax benefits or reductions in income taxes. Such policy is presently being pursued by the regulatory agencies referred to, and unless corrections are made in this legislation, they may continue to do so.

The consequence of such action is rank discrimination against the regulated industry, in that the very purpose and reason for accelerated depreciation is defeated, and the Treasury of the United States is deprived of substantial tax revenue. The latter point being expressly pointed out by Assistant Secretary of the Treasury Edwin S. Cohen in his testimony to the Congress.

It should also be pointed out that the former Chairman of the Federal Power Commission, the Honorable Lee C. White, told the Ways and Means Committee of the House of Representatives on March 25, 1969, that the taxes payable by natural gas pipeline companies in 1967 were *reduced* by about $72 million due to the use of the "flow through" policy referred to. Such policy also operates to deny to the regulated industry the much needed funds intended by the Congress to be available to industry for investment in new plant and equipment. Hence, the natural gas pipeline industry, as one of the regulated industries, is forced to go into the highly competitive money markets of the nation in order to acquire the funds necessary to carry out its responsibilities in providing and furnishing gas to meet the rapidly expanding demands throughout the nation, especially in the metropolitan areas. In order to get these funds, the natural gas pipeline industry, a highly debt-structured industry (perhaps the highest with the exception of the housing industry), must compete with all others seeking additional funds. The result has been constantly increasing interest rates, which are now in excess of 8½% and may be expected to continue to climb in the absence of a realistic approach to such problems as those outlined in this presentation. Thus, the present policy of the F.P.C. obviously contributes measurably to the inflation spiral and also to the increased cost to the consumer. It is the opinion and view of INGAA that the "flow through" policy of the regulatory agencies is in violation of the clear intent of Congress, results in discrimination against the regulated industry, is a disservice to the consumers of products and services subject to regulation, deprives the United States Treasury of much needed revenue, and is not in the best interest of the general economy of the country.

It is the further opinion of INGAA that Section 451 of H.R. 13270, which would amend Section 167 of the Internal Revenue Code, does not cure the problems outlined nor afford the remedy so badly needed.

We believe that the taxpayer, whether regulated or non-regulated, should, in the exercise of his best busines judgment, have the freedom of electing that method of depreciation authorized in Section 167 which is best suited to his needs; and that such election should be completely free of any interference from regulatory agencies. We firmly believe that no regulatory agency with authority to establish or approve the rates of any taxpayer should, without the consent of the taxpayer, specify or prevent a change of the method or rate of depreciation allowable under the Code used or proposed to be used by such taxpayer in computing the amount of its Federal income tax. We further believe that no regulatory agency, in determining the taxpayer's expense for Federal income tax, should be allowed to utilize any other method of depreciation other than that used or proposed to be used by the taxpayer in computing its Federal income tax nor be permitted to exclude from such tax expense, either directly or indirectly, the amount of any reduction in Federal income tax payable for any period utilized by the regulatory agency in establishing the taxpayer's cost of service.

In short, it is the strong opinion of INGAA that the choice of the method of depreciation to be used by the taxpayer from among those methods authorized by law should be solely the choice of the taxpayer, and that such choice be inviolate for all purposes.

We fully appreciate the dilemma faced by this Administration with relation to Treasury revenues because of the trend toward the "flow through" of accelerated depreciation tax benefits. However, we would hasten to point out that the change over by many of the regulated industries has been the result of implied threats by the regulatory agency having jurisdiction to impute to such industries the "flow through" theory in fixing "cost of service" for rate making purposes. In short, the change over has been involuntary. It is like telling a man that unless he moves he will be "snake bit." The chances are he would move. Such has been the case in many instances of natural gas pipeline companies in moving over to the flow through method of accounting. Some of them would like to return immediately to either straightline depreciation or to accelerated depreciation with normalization. Some of them find that they canot immediately make such change because their programs have been worked out over a period of several years using the flow through method which was virtually forced upon them.

Under the circumstances the proper solution to the problem faced by the Treasury and also by the companies, would seem to be an authorization for those companies to return to a slower method of depreciation but not allowed to go to a faster depreciation. In other words, if Section 167 of the Internal Revenue Code could be amended to provide the election to the taxpayer to remain on the method of depreciation being used as of July 22, 1969, or to return to a slower depreciation, any moves from flow through to normalization or straight line would result in additional revenues to the Treasury on an early basis and substantial increases on a long range basis. It would also enable the regulated companies to have flexibility in meeting their capital needs for expansion requirements, and would be a contribution toward the solution of the inflationary problem.

This could be done as to both old and new property, as defined in H.R. 13270, and the result would be additional revenues to the Treasury. A suggested amendment is attached hereto and made a part of this statement for all purposes, which in the opinion of INGAA, will accomplish the results sought. Unless such an amendment or one of a similar nature accomplishing the purposes outlined, is adopted, there will result rank discrimination and unfairness as between regulated and non-regulated industries and also as between regulated industries. It should be noted that as the "flow through" policy was developing in the minds of the regulatory agencies, some of those agencies moved faster than others in indicating to those companies under their jurisdiction, the intention to adopt flow through policies for rate making purposes. Hence, many of the companies that moved to "flow through" before July 22, 1969, because of such indications or implied threats as the case may be, find themselves frozen into "flow through" on both old and new property, under the provisions of the language adopted by the House of Representatives (Section 451 of H.R. 13270) unless permitted by the regulatory agency to change. Other companies which had not moved into the flow through method but had continued to use straight line depreciation may remain on straight line depreciation both as to old and new property. The taxpayer using accelerated depreciation on or before July 22, 1969, and normalizing, would be allowed to continue to use accelerated depreciation and to normalize with respect to old property. If the taxpayer was using accelerated depreciation and flowing through, he would be required to continue to use such practice in the absence of permision by the regulatory agency to go to a slower depreciation. In other words, he would be frozen into the "flow through" method, even though he had adopted such method against his best business judgment and only because of the insistence of the jurisdictional regulatory agency.

With relation to new property (property completed or acquired after December 31, 1969), a taxpayer on straight line or on accelerated depreciation with normalization would be permitted to take accelerated depreciation and normalize. If the taxpayer was on flow through as of July 22, 1969, he would have no choice but to stay on flow through unless he could get the permission of the regulatory agency having jurisdiction, to return to a slower method of depreciation, a permission that could not be obtained under any circumstances insofar as the Federal Power Commission is concerned unless the said Federal Power Commission changes the policy it has pursued to the date.

The unfairness with relation to regulated industries forced into the flow through method of accounting is quite obvious, and in the opinion of INGAA should be changed.

INGAA respectfully submits to this Honorable Committee and the Congress that fairness in the application of tax requirements or benefits demands uniformity in the law as applicable to both regulated and nonregulated industries, and especially is this true with regard to the several industries falling within the category of the "regulated" field. It is the position of INGAA that all regulated industries now using the "flow through" method of accounting for depreciation purposes should be given the right and option as to both old and new property to change such accounting method to a slower method of depreciation, to wit, "straight line" or "accelerated depreciation with normalization," but not be required to. All companies presently using accelerated depreciation and normalizing should be allowed to continue such accounting practice as to both old and new property, or to go to a slower depreciation on either type of property or both types, but not be required to. Those companies presently using the straight line method of accounting for depreciation purposes should be permitted to use accelerated depreciation with normalization on new property.

If the Congress will adopt such policy, it is the opinion of INGAA that the best interests of the country will be served.

Reduction in the Depletion Allowance for Oil and Gas

INGAA respectfully submits that it is unqualifiedly opposed to any reduction in the 27½% depletion allowance on oil and gas which has been in effect for more than forty years.

A review of history will reveal that at the time of the adoption of the percentage depletion formula in 1926, the Treasury of the United States, having made a thorough and complete study of the issue, recommended more than 30% as an appropriate and fair figure. The 27½% was the result of a compromise. It has been attacked annually for many years and has always withstood the onslaughts directed against it, because it is reasonable, just, fair, and has served to produce the incentive for the tremendous progress enjoyed by this country in the development of oil and gas. That incentive made it possible for this country to move to the forefront in the exploration, discovery and development of great petroleum resources in our nation. Resources without which this country could well have been the loser in armed conflict that has challenged free man constantly during this century. Resources that not only provided the major difference in our defense posture, but served as the basis for the greatest advancement of mankind in contributions to the needs and requirements of the individual during peace time. There is no area of human need or endeavor in which petroleum does not play some substantial role. I have often wondered in my own mind what the picture would be today had there not been an incentive to promote and foster the search for oil and gas, such as the 27½% depletion allowance. Would there have been a North Slope of Alaska? Would there have been a Texas Panhandle field? Would there have been an East Texas field? Would there have been many of the discoveries on foreign soil? Would America have won World War II? What would be the situation in the field of medicine, to which petroleum products have so measurably contributed? What would have happened to our automobile industry or to the labor groups? This same question could be asked about every phase of American life since the original discovery of oil in Pennsylvania.

Some may say that there is no relationship between the 27½% depletion allowance and the great strides that we as a nation have made, both collectively and individually. However, the facts of history simply do not bear out such an allegation. It has been the hope of reward that has spurred on the single wildcatter, the small partnership, the corporations and combinations of these entities to risk their time, their energies and their worldly goods in the quest for petroleum products. It has been the product of that quest that has made this country the world's leading producer of petroleum products over the years and the world's greatest consumer of those products. In 1967 the records reflect that there were 5,260 new-field wildcat wells drilled, 4,700 of which were dry holes. This reflected a productive percentage of only 10.6%. Had it not been for depletion allowance and the expensing of intangible drilling costs, no one would be naive enough to suggest that such a drilling program could have been mounted. If either or both of these incentives are measurably reduced or destroyed, it is almost certain to follow that there will be a substantial reduction in wildcat wells drilled and in new-field wildcat wells drilled. Even under present circumstances, records reflect that there has been a constant reduction in wildcat wells drilled from 12,000 plus in 1956 to 6,026 in 1967. In new-field wildcat wells drilled, the reduction has been constant since 1956 from 8,709 to only 5,260 in 1967.

INGAA realizes that this Honorable Committee has received a great and varied amount of statistics on this subject. It is not our purpose to indulge in repetition, but we do hope that the gravity of the situation has been made clear and that this Committee will conclude that the true value of the depletion allowance has been proven many, many times.

One might ask why the gas pipeline industry would have an interest in a matter that should be of greatest concern to the oil industry. The answer is quite obvious. Gas for many years was looked upon as a by-product of the oil business, without any great value. Wells were drilled for oil, not gas. Gas was discovered while the search was being made for the oil. It was during World War II that the great need for energy opened the door for the large interstate pipelines to be constructed and provided the opportunity for gas to assume its proper role in the energy requirements of this nation. Today gas provides one-third of the energy requirements of our country, and the demand for additional service and supplies is constantly rising. Hence, natural gas is the lifeblood of the pipeline industry. Unless it is available in appropriate quantities, the industry itself will suffer measurably, the serious effects on the industries utilizing it cannot be over emphasized, and cold homes and apartments would not be an idle thought. As before mentioned, the demands for natural gas are on the constant increase. It is estimated at the present time that such requirements will increase at the rate of about 4% per annum. New gas discoveries are not keeping pace with demand. For the first time since 1946 the records reflect that natural gas production in 1968 exceeded new discoveries. Total reserves showed a decline over the previous year of 1967. Additions to reserves were approximately 6 trillion cubic feet *less* than the amount produced in 1968. The Federal Power Commission in July of this year reported that domestic natural gas reserves of 64 major pipeline companies dropped during 1968. In recent months pipelines and distributors have experienced difficulties in contracting for anticipated requirements, and in a number of instances have not been able to obtain the needed gas. These declines, if allowed to contine, coupled with the population explosion in this country, could signal the beginning of a most critical stage in the ability of this country to meet its energy requirements.

It would appear that the logical, the sensible, and the realistic approach at this time would be for the Administration and the Congress to be searching for new ways to promote the exploration and discovery of petroleum products. Certainly it is not the time to reduce the incentives presently available and thereby create a risk that this country cannot afford to take. If there was ever a time in the history of this country when we need to search out every possible source of energy in the continental United States, it is now. We are well aware that much has been said about the potential reserves of oil and gas in this country. The Potential Gas Committee, which has done an admirable job in association with the Colorado School of Mines, has estimated future potential gas reserves of 1,230 trillion cubic feet, both on shore and off shore in the continental United States. This all sounds wonderful, but the word "potential" cannot be associated with "known reserves." If these potential estimates are to be realized, there must be a measurably stepped-up exploratory effort resulting in new discoveries. Results that will not come about unless proper incentive is present.

It is the opinion of INGAA that the most sensible investment this country could make at this time would be to retain the incentives presently available in the oil and gas industry, and if necessary, to add thereto rather than subtract therefrom. If such a course is followed, the average American citizen will be the beneficiary, both from a personal and a national standpoint.

Amendments Proposed by the Independent Natural Gas Association of America to H.R. 13270

On page 266, strike out lines 14 and 15 and insert in lieu thereof the following:

"(B) the requirements of paragraph (2), to the extent applicable, are met with respect to such property."

On page 266, line 16, strike out the phrase "Continuation of Normalization" and insert in lieu thereof "Elections."

On page 266, after line 25, add the following new paragraph:

"In the case of public utility property described in paragraph (1) with respect to which (or with respect to property of the same kind) the taxpayer as of July 22, 1969, used a method of accounting other than normalization, the taxpayer may continue to use a method other than the straight line method with respect to such property for the purposes of computing taxable income, or such taxpayer may elect to utilize a straight line method of depreciation for computing taxable income with respect to such property.

"In the case of public utility property described in paragraph (1) with respect to which (or with respect to property of the same kind) the taxpayer as of July 22, 1969, used a method of accounting other than normalization, the taxpayer may adopt the normalization method of accounting with respect to such property.

"No agency or instrumentality, commission, or other similar body with authority to establish or approve the rates of any taxpayer shall, either directly or indirectly, limit the elections of such taxpayer as herein described."

On page 267, line 18, after the period, insert the word "or," and add a new paragraph to be designated (C) to read as follows:

"(C) the taxpayer referred to in (B) above elects to use the normalization method of accounting with respect to such property. No agency or instrumentality, commission, or other similar body with authority to establish or approve the rates of any taxpayer shall, either directly or indirectly, limit the election of such taxpayer as herein described."

Senator ANDERSON. The next witness is Mr. William Jackman.

STATEMENT OF WILLIAM JACKMAN, PRESIDENT, INVESTORS LEAGUE, INC.

Mr. JACKMAN. Mr. Chairman, I have received a telegram from the committee which permitted me to include my capital gains statement and the depletion statement all in one, to prevent my having to make two different appearances, and that is the reason I am doing it today.

I am William Jackman. I am president of the Investors League in New York City. I reside in East Orange, N.J., and we have thousands and thousands of members residing in every State in the Union. So, it must be obvious why I am before this committee.

If Winston Churchill were around today, I am afraid he might say that yours is a monumental task, and may God be with you during your deliberations.

Senator BENNETT. Excuse me, just a minute. We have had a call from the Senate.

(Discussion off the record.)

Senator BENNETT. Mr. Jackman, I notice that you have a text for what I assume is a summary.

Mr. JACKMAN. Yes.

Senator BENNETT. Which will consume all of your time.

I notice you are getting off of your text. I thought that I had better warn you.

Mr. JACKMAN. Well, I will not do that.

Mr. BENNETT. I did not see Winston Churchill in the text.

Mr. JACKMAN. No, I just thought I would inject that, because I think it is rather appropriate.

Nevertheless, the tax reform bill, H.R. 13270, which had passed the House by a majority of 394 to 30, is, in my personal opinion, a bill that was conceived and enacted in astonishing haste without giving the legislators time to digest it. Even Mr. Mills of the Ways and Means Committee had to confess himself confused. He had to reassemble his committee to amend the rate schedules for low-income taxpayers because of what he called misunderstanding.

A further indication of the haste in which this legislation was considered by the Ways and Means Committee was the extraordinary session called by the committee on the day before the bill was scheduled for action on the floor because it had somehow overlooked millions of potential beneficiaries.

Even more astounding was the fact that these persons were in the $7,000 to $12,000 annual income group, the so-called middle income.

This oversight was quickly corrected by the committee, although the action cost the Government $2.4 billion in anticipated lost revenue.

It adds untold pages to the "infernal" Revenue Code, magnifying the complexity of existing conditions. It is time for the Congress to realize that true tax reform can only be achieved through simplification.

In the tax reform bill of 1969, there are provisions to increase the maximum rate on long-term capital gains from 25 to 30 percent—and this is the crux of my argument—indicating the Treasury would gain $300 million of new revenue from this source if this were accomplished.

The facts are contradictory. The Treasury would lose money if its provisions remain in the bill. Investors would not sell. They would be frozen.

A recent survey that was conducted by the New York Stock Exchange, by Louis Harris and Associates, shows that if the long-term capital gains were reduced from 25 to 12½ percent, the Treasury would receive an estimated $2.5 billion in revenue. That is over $2 billion more than they are presently receiving.

A similar survey was conducted by the Investors League of its own members and substantiated these figures.

When the Government needs revenue and can get it from a tax decrease, why shouldn't it do so?

The capital gains tax is not a tax on income at all. A man is no richer nor poorer when he sells an asset and reinvests it in another. Secretary of the Treasury Kennedy expressed concern about the bias in the bill against the investment in favor of consumption, saying that the overweighting embodied in the proposed treatment of capital gains as well as corporate tax increases could impede economic growth in the years ahead by curtailing the incentives to make productive investments.

We are opposed to the imposition of the capital gains tax at the time of death for the same reasons. If the capital gains tax is retained in 13270, the Tax Reform Act of 1969, in the bill's final form, we are headed for an investors tax strike.

The action of the stock market indicates to me that America's 27 million investors are in a mood for such a movement. It will not materially relieve the long-suffering public, nor will any kind of tinkering tax reform in itself. Only good sense in Congress and sound Federal housekeeping can do it.

Honest tax relief from high taxes and reversal of inflation as well can only be brought about by curtailment of runaway Federal spending. We must not forget, gentlemen, that it costs approximately $30,000 to put a man to work, and if the investor does not furnish this money, who will? We will go to socialism.

Now, in reference to depletion, it is very simple. I remember not very long ago when I was talking on the question of natural gas—at that time I knew nothing about natural gas—I went to the fields and saw what they had to do. And prior to that time, all I knew about gas was that if you burped, you got rid of it; but, after that, I saw what had to be done. It is not any wonder that you have to put up $100,000 to dig a hole.

Therefore, I would sum up my depletion statement by saying the percentage depletion is not a tax loophole.

No. 2, the phrase "oil depletion allowance" is a misnomer.

3. Ours is an energy-based economy with oil and gas supplying nearly three-fourths of the energy.

4. The petroleum industry pays its fair share of domestic taxes. We have heard that this morning.

5. Percentage depletion does not produce excessive profits for oil companies.

6. The real beneficiary of depletion, percentage depletion, is the American consumer.

7. Percentage depletion has worked. We will not have a pilepine across the Atlantic Ocean in the next war, if we have one.

We cannot afford to let ourselves become dependent on foreign oil, and our testimony includes in exhibit "A" and lists all of the minerals to which the depletion allowance applies.

So, I say, gentlemen, it is a question here of compromise, and, again, I will go back to Mr. Churchill and say, in conclusion, that Government is the art of compromise, but there comes a moment in the lives of men when to stoop before the altar of expediency is to sacrifice your birthright. God forbid you should do that.

Thank you very much.

Senator CURTIS. I think Mr. Jackman has made his points very well. I do not know when we will be called to the floor. There are other witnesses to be heard, and I will forego the temptation to express my agreement with him.

Mr. JACKMAN. Thank you so much, sir.

Senator BENNETT. He means he agrees with you but he foregoes the temptation to tell you so.

Senator CURTIS. To illustrate.

Senator BENNETT. Thank you, Mr. Jackman.

(Mr. Jackman's prepared statement follows:)

STATEMENT OF INVESTORS LEAGUE, INC., BY WILLIAM JACKMAN, PRESIDENT

SUMMARY

My name is William Jackman. I am president of Investors League, Inc., 84 Fifth Avenue, New York, N.Y. and a voting resident of East Orange, N.J. The Investors League is a non-profit, non-partisan voluntary membership organization of thousands of businessmen and investors, large and small, residing in all of the fifty states of the nation.

CAPITAL GAINS

Mr. Chairman and members of the Committee, the Tax Reform Bill of 1969 (H.R. 13-270) passed in the House by a majority of 394 to 30. It is my personal opinion that this bill was conceived and enacted in astonishing haste without giving the legislators time to digest it.

Even Chairman Mills of the House Ways and Means Committee, had to confess himself confused. He had to reassemble his Committee to amend the rate schedules for low income taxpayers because of what he called a "misunderstanding."

A further indication of the haste with which the legislation was considered by the Ways and Means Committee, was the extraordinary noon session called by the committee on the day before the bill was scheduled for action on the floor because it had somehow "overlooked" millions of potential beneficiaries. Even more astounding was the fact that these persons were in the $7,000 to $12,000 annual income group, the so-called "middle-income" taxpayer. *This oversight was quickly "corrected" by the committee*, although the action cost the government $2.4 billion in anticipated lost revenue.

It adds untold pages to the Internal Revenue Code greatly magnifying the complexity of existing conditions. It is time for the Congress to realize that true tax reform can be achieved only through simplification.

In the Tax Reform Bill of 1969 there are provisions to increase the maximum rate of the long term capital gains from 25% to 30%, indicating that the Treasury would *gain* $300 million in new revenue from this source if this were accomplished. The facts are contradictory. The Treasury would *lose* money if this provision remains in the bill. Investors wouldn't sell.

A recent survey conducted for the New York Stock Exchange by Louis Harris and Associates, Inc. showed that if the long term capital gains tax were reduced from 25% to 12½%, Treasury would receive an estimated $2.5 billion in revenue—over $2 billion *more* than the $500,000 million they now receive under present rates.

A similar survey recently conducted by the Investors League of its own members, substantiated these figures.

When the government needs revenue and can get it from a tax decrease, why shouldn't it do so?

The capital gains tax is not a tax on income at all. A man is no richer nor poorer when he sells an asset and reinvests it in another.

Secretary of the Treasury Kennedy, expressing concern "about the bias in the bill against investment in favor of consumption," said this overweighting embodied in the proposed treatment of capital gains, as well as corporate tax increases, could impede economic growth in the years ahead by curtailing the incentive to make productive investments.

We are opposed to imposition of a capital gains tax at time of death or gift for the same reasons.

If the capital gains tax increase is retained in H.R. 13270, the Tax Reform Act of 1969 in the bill's final form, we are heading for an investors tax strike. The action of the present stock market indicates to me that America's 27 million investors are in the mood for such a movement.

Loophole closing will not materially relieve the long-suffering public, nor will any kind of tinkering tax "reform" in itself. Only good sense in Congress and sound Federal houskeeping can do it. Honest tax relief from high taxes—and reversal of inflation as well—can only be brought about by curtailment of runaway Federal spending.

We must not forget that it cost approximately $30,000 to put a man to work and if the investor does not furnish this money, who will?

OIL AND NATURAL GAS DEPLETION

1. Percentage depletion is not a tax loophole.
2. The phrase "oil depletion allowance" is a misnomer.
3. Ours is an energy-based economy—with oil and gas supplying nearly three-fourths of that energy.
4. The petroleum industry pays its fair share of domestic taxes.
5. Percentage depletion has not produced excessive profits for oil companies.
6. The real beneficiary of percentage depletion is the American consumer.
7. Percentage depletion has worked.
8. We cannot afford to let ourselves become dependent on foreign oil.
9. Our testimony includes "Exhibit A" which lists all of the minerals to which the depletion allowance applies.

STATEMENT

Mr. Chairman and members of the Committee, I wish to thank you for the privilege of presenting this statement before your committee on behalf of America's many millions of tax-paying voting investors (who are also consumers) on H.R. 13270 the Tax Reform Bill of 1969 now before you.

This Bill passed the House by a majority of 394 to 30 which was utterly ridiculous. It was conceived and enacted in astonishing haste without giving the legislators sufficient time to study and digest it and there was no opportunity for amendments from the floor of the House. It was found irresistable also because it promised low-income and middle-income taxpayers about $9.2 billion in tax-relief. As Assistant Secretary of the Treasury, Edwin S. Cohen, ruefully put it, the House Tax "reform" bill might better be known as "the lawyers and accountants relief act of 1969."

Another stinging rebuke to those who favorably reported the Tax Reform Act out of the Ways and Means Committee was offered by Congressman James B. Utt, an important member of this Committee. Said Mr. Utt: "This tax reform bill follows past practices in enacting patchwork provisions to the code—History shows that this approach adds untold additional pages to the Internal Revenue Code, greatly magnifying the complexity of existing provisions. The more complex the law becomes the greater the number of inequities we face."

"It is time for the Congress to realize that true tax reform can be achieved only through simplification. Tax simplification can be achieved by a broadening of the base and a reduction of the rates. By achieving this goal, the incentive for avoiding taxes through a variety of sophisticated devices diminishes".

Since many of the bills provisions of the Act were announced piecemeal, at least in principle, there was a general understanding that the bill would help the low income taxpayer and soak the wealthy taxpayer; but since many of the provisions had not been put into precise language, and no committee report was available, there was considerable confusion as to what had actually been done. In a tax bill, the exact words are more important than the generalities.

Even Chairman Mills of the House Ways and Means Committee, had to confess himself confused. He had to reassemble his Committee to amend the rate schedules for low income taxpayers because of what he called a "misunderstanding". As it turned out, a $2.4 billion misunderstanding. A summary of the bill was finally made available, but it takes time to digest 226 pages of tax-prose and another 143 pages of "technical explanation" even if you're a Philadelphia lawyer.

As a clear indication of the haste with which the legislation was considered even by the Ways and Means Committee, Rep. Peter H. B. Frelinghuysen (N.J.) and others have pointed to the extraordinary noon session called by the committee on the day before the bill was scheduled for action on the floor because it had somehow "overlooked" seven million potential beneficiaries.

Even more astounding was the fact that these seven million persons were in the $7,000 to $12,000 annual income group, the so-called "middle-income" taxpayer. This oversight was quickly "corrected" by the committee, although the action cost the government $2.4 billion in anticipated lost revenue.

In a separate statement of his views in the Ways and Means Committee report, Rep. James B. Utt (R.-Calif.) one of the committee members, made some telling criticisms. The committee, he said, simply did another patchwork job. By trying to "delineate tax equity with needle-like precision", it made the law immensely more complex and onerous for the individual taxpayer than it already was. Tax simplification, he insisted, which should have been given No. 1 priority, was forgotten.

"It is certainly anomalous", added Mr. Utt, "to recommend passage of the surtax for a full year on the theory that we need additional revenues to reduce present severe inflationary problems while at the same time providing a tax decrease of nearly $2 billion. But this is precisely what the committee has done. . . The revenue reductions in this bill will grow from nearly $2 billion in fiscal 1970 to nearly $7 billion in fiscal 1975, and this is bound to aggravate our problems with inflation. . . Since any surplus we will realize is due to an excess of trust funds receipts over disbursements, the federal budget on a federal funds basis will continue to be in deficit".

The statement did not mention that even since the tax cuts were passed by the House, the President had not yet put forward his guaranteed income proposal which would add from $4 billion to perhaps $10 billion a year of government outlays and increase the inflation probability all the more.

In the Tax Reform Bill of 1969 before your Committee to *increase* the maximum tax on long term capital gains from 25% to 30% indicating that the Treasury would *gain* $300 million of new revenue from this source if this were accomplished. Who on earth has arrived at this assumption. I would like one of you gentlemen to explain it to me. The facts are contradictory. The Treasury would lose money if the Senate Finance Committee allowed this provision to remain in this Bill.

Congressman Mr. Utt, on August 6, 1969 made the following observation: *"The last item and, to me, the most deadly to the American free enterprise sys-*

tem, is the tax treatment given to capital gains. Some one has convinced the majority of our committee that there is no difference between capital and earned income. That is a deadly assumption. Capital is the thing that makes possible creative risk investments, and is entitled to separate and preferred treatment. The history of the great economic progress in America has been based on the willingness of millions of individuals to risk their hard-earned cash for research, development, expansion and production of goods in America. We stand today on the threshold of the greatest opportunity in our history to perfect and produce gadgets of every sort and description at cheaper and cheaper prices in order to give America a still higher standard of living than we have now. We must not destroy that incentive; that creative imagination which can give us the greatest progress in our history. Here, again, we are stymied by the Marxian doctrine of social reform through taxation. When capital gains taxes were under discussion a few years ago, and Mr. George Meany was on the stand, I (Congressman James B. Utt) asked him if he believed in taxation for revenue or punitive purposes. He quickly replied "for revenue." Then, I said, "Mr. Meany, studies have been made by The Brookings Institute which showed that if you reduced the capital gains alternative tax and reduced the holding period, there would be more than a trillion dollars worth of real estate and stocks which would become unfrozen and would double the amount of revenue from the capital gains sector." He replied, "Yes, Mr. Utt, but that would be socially unjust." In that statement alone is the fallacy of his whole reform legislation."

A recent survey conducted for the New York Stock Exchange by Louis Harris and Associates, Inc. (See Exhibit "A" attached) showed that if the long term capital gains tax were reduced from 25% to 12½%, the Treasury would receive an estimated $2.5 billion in revenue—over *$2 billion more* than the $500,000 million they now receive under the present rates.

A similar survey recently conducted by the Investors League of its own members substantiated these figures.

When the government needs revenue and can get it from a tax decrease why shouldn't they do so?

The one-sidedness of the new bill is particularly glaring in its harsh treatment of capital gains.

The bill increases from six months to 12 months the period during which an asset must be held if the receipts from its sale are to be treated only as long-term gains subject to lower tax rates. But the highest tax even on long-term capital gains is no longer to be 25 percent; it will be one-half the tax rate on regular income, and so can rise to 35 per cent to taxpayers in the highest brackets.

The attitude of successive Administrations and Congresses toward capital gains has been hypocritical, a cynical heads-I-win tails-you-lose treatment of the taxpayer. If Congress really believed, as it professes to, that net short-term capital gains are justly treated as a full addition to ordinary income, then it should agree that net short-term capital losses should be deductible in full against the same year's ordinary income.

Or if it is right that half of all net long-term capital gains in a given year should be added to that year's ordinary income and taxed as such, as they are, then half of all net long-term capital losses in a given year should be deductible against that year's ordinary income. But no member of Congress even mentions any such even-handed treatment.

As a result of the inflation of the last 36 years, people have been paying taxes on "capital gains" that are in fact non-existent.

For instance, suppose you bought stock or real estate for $10,000 in 1939 and sold it for $26,400 today. You would be taxed for a capital gain of $16,400. Actually, as the cost of living has also risen 164 percent in this period, you would have achieved no real capital gain at all. Your $26,400 would buy no more than $10,000 bought in 1939.

There are at least a dozen different possible reforms of the capital gains tax, any one of which would make it less one-sided. I suggest we begin with this one: When a taxpayer sells shares or a piece of property held over a long period, he should be permitted to calculate his real gain (or loss) by reducing his nominal money gain against the increase in the official price index since the year in which he originally acquired the property.

To expect this is probably utopian. But is it even utopian to hope that at least a few of the abuses in the House tax bill can be corrected in the Senate by this Committee?

EXHIBIT "A"

TABLE I

STOCKHOLDINGS OF 1494 INDIVIDUALS

Value of Stock Held (At Price Levels of Dec. 31, 1964)	$66,268,000
Market Value of Stock When Purchased	29,813,000
Unrealized Capital Appreciation	36,455,000

AT CURRENT CAPITAL GAINS TAX RATE (25% Maximum)		
Would Sell in 1965	$ 1,515,000	
Capital Appreciation Realized		$ 490,000
WITH 50% CUT IN CAPITAL GAINS TAX (12½% Maximum)		
Would Sell in 1965	11,526,000	
Capital Appreciation Realized		5,714,000

IF THE PRESENT CAPITAL GAINS TAX RATE REMAINS UNCHANGED —MAXIMUM TAX OF 25%:

The indicated annual market value of sales of stock by all individual investors would total about $10.3 billion—of which some $3 billion would represent capital appreciation subject to the capital gains tax.

In terms of revenue, the Treasury would receive an estimated $440 million.

*All tax implications described in the survey assume an expanding economy which will follow the same basic growth patterns evident in recent years. Were the price level of the market to drop appreciably, the net gain could be substantially less than is indicated in this report.

TABLE II

TOTAL INDIVIDUAL SHAREHOLDINGS IN PUBLICLY OWNED CORPORATIONS ESTIMATES OF AMOUNT OF UNLOCKED CAPITAL AND IMPACT ON FEDERAL REVENUES UNDER THREE ASSUMED CAPITAL GAINS TAX SITUATIONS

Estimated Value of Stock Held (Dec. 31, 1964)	$386,980,000,000
Estimated Unrealized Capital Appreciation	208,300,000,000

AT CURRENT CAPITAL GAINS TAX RATE (25% Maximum)			
Would Sell in 1965	$10,340,000,000		
Capital Appreciation Realized		$ 2,970,000,000	
Tax To Treasury			$ 440,000,000
WITH 50% CUT IN CAPITAL GAINS TAX (12½% Maximum)			
Would Sell in 1965	67,320,000,000		
Capital Appreciation Realized		29,220,000,000	
Tax To Treasury			
Initial Sales			2,490,000,000
Annually After Leveling Off			760,000,000

IF THE CAPITAL GAINS TAX RATE WERE REDUCED TO A MAXIMUM OF 12½%:

The market value of sales by all individual investors would soar from $10.3 billion to $67.3 billion. Total capital appreciation of $29.2 billion would become subject to the lower capital gains tax rate. Thus:

Nearly seven times as much stock would be sold.

Nearly ten times as much capital appreciation would be unlocked and thus become subject to the lower capital gains tax rate

IN TERMS OF DOLLARS..

$57 billion more of capital would be freed for reinvestment than under the present rates.

AND

The Treasury would receive an estimated $2.5 billion in revenue—over $2 billion more than under the present rates.

CAPITAL GAINS TAX AT DEATH

We are opposed to the imposition of a tax at capital gains rates on all net gains accrued on capital assets at the time of transfer at death or gift. We are equally opposed to carrying over the decedent's basis for property included in his estate.

A tax on appreciation at death would lead to substantial shift of equity investment to sheltered investments. If done on a large scale, this could have a serious effect on the investment markets and attitudes of investors. The use of substituted bases is completely unworkable from a record keeping standpoint. *The problem of trying to establish fair market values for all properties as of the date a new tax reform bill becomes law would be fantastic. It would parallel the problem we had for decades in determining the value of property as of March 1, 1913.*

A tax on appreciated property not sold or exchanged would constitute a new capital levy on death. In effect, it would be an additional estate tax imposed specifically on those persons who have been successful in taking the investment risks which are a most important part of our economic system.

DEPLETION ALLOWANCES

I now will discuss sections of the bill which pertain to lowering the depletion rate on oil and natural gas from 27½% to 20%. We oppose lowering such rates for the following reasons:

First. Percentage depletion is not a tax loophole. It was deliberately devised by Congress more than 40 years ago and is consistent with the policy of not taxing capital value as income.

Second. The phrase "oil depletion allowance" is a misnomer. This provision applies to more than 100 different minerals important to our national welfare and to the economies of every State.

Third. Ours is an energy-based economy—with oil and gas supplying nearly three-fourths of that energy. Percentage depletion is essential if the industry is to meet the anticipated tremendous future demand for petroleum.

Fourth. The petroleum industry pays its fair share of domestic taxes—exactly the same percentage of its revenue as other industries, according to authoritative studies.

Fifth. Percentage depletion has not produced excessive profits for oil companies; in fact, their profits have averaged slightly less than those of manufacturing industries as a whole.

Sixth. The real beneficiary of percentage depletion is the American consumer. If the mineral depletion provision were deleted from our tax laws, the consumer would have to pay more for his every purchase since the cost of both the raw material in the product and the energy required to produce it would be more expensive.

Seventh. Percentage depletion has worked. It has enabled the petroleum industry and other mineral producing enterprises to meet the rapidly rising demands of an industrial civilization in peacetime, wartime, and the cold war era. It has helped keep our standard of living the highest in the history of the world. And, if we want an especially timely reminder of the value of percentage depletion, all we have to do is read any morning's headlines about what is going on in the Middle East.

Eighth. We have just seen the nationalization of oil properties of several American companies in the Middle East. How much more of a warning do we need that we cannot afford to let ourselves become dependent on foreign oil any time or anywhere in the world? We need percentage depletion because we need to maintain our national independence and our vital fuel supply. It is as plain and simple as that. And if we can learn anything at all from the news of the day, it is that percentage depletion—far from being a loophole is a lifeline for America.

Gentlemen, I thank you.

(See Exhibit "A" attached) Percentage Depletion Rates for Mineral Production.

Exhibit "A"

Percentage Depletion Rates for Mineral Production

Since 1926, the Internal Revenue Code has authorized percentage depletion at a 27½% rate for oil and gas wells. This rate is applied to the gross income from the wells, subject to a 50% of net income limitation.

During the decades that percentage depletion has been a part of the revenue laws, it has been extended to almost all other U.S. minerals at rates ranging from 5 to 23% of gross income from the mineral producing property, as follows:

TWENTY-THREE PERCENT DEPLETION APPLIES TO THESE MINERALS

Antimony.
Anorthosite (to extent alumina and aluminum compounds extracted therefrom).
Asbestos.
Bauxite.
Beryl.
Bismuth.
Cadmium.
Celestite.
Chromite.
Clay (to extent alumina and aluminum compounds extracted therefrom).*
Cobalt.
Columbium.
Corundum.
Fluorspar.
Graphite.*
Ilmenite.
Kyanite.
Laterite (to extent alumina and aluminum compounds extracted therefrom).
Lead.
Lithium.
Manganese.
Mercury.
Mica.
Nephelite Syenite (to extent alumina and aluminum compounds extracted therefrom).
Nickel.
Olivine.
Platinum.
Platinum Group Metals.
Quartz Crystals (Radio Grade).
Rutile.
Block Steatite Talc.
Sulphur.
Tantalum.
Thorium.
Tin.
Titanium.
Tungsten.
Uranium.
Vanadium.
Zinc.
Zircon.

FIFTEEN PERCENT DEPLETION APPLIES TO THESE MINERALS

Aplite.
Barite.
Bentonite.
Borax.
Calcium Carbonates.
Clay, Ball.*
Clay, China.*
Clay, Refractory & Fire.*
Clay, Sagger.*
Copper.
Diatomaceous Earth.
Dolomite.
Feldspar.
Fullers Earth.
Garnet.
Gilsonite.
Gold.
Granite.
Graphite (Flake).*
Gypsum.
Iron Ore.
Limestone.
Magnesite.
Magnesium Carbonates.
Marble.
Metal Mines (not otherwise named).
Mollusk Shells (when used for chemical content).*
Molybdenum.
Phosphate Rock.
Potash.
Quartzite.
Rock Asphalt.
Silver.
Slate.*
Soapstone.
Stone (dimension or ornamental).*
Talc.
Thenardite.
Tripoli.
Trona.
Vermiculite.
Other minerals not covered elsewhere.

*Note differing rates, depending on use.

TEN PERCENT TO THESE MINERALS

Brucite.	Perlite.
Coal.	Sodium Chloride.
Lignite.	Wollastonite.

FIVE PERCENT TO THESE MINERALS

Clay (used for drainage and roofing tile, flower pots, etc).*

Gravel.	Sand.
Mollusk Shells.*	Scoria.
Peat.	Shale.*
Pumice.	Stone.*

If from Brine Wells—Bromine, Calcium Chloride, Magnesium Chloride.

SEVEN AND ONE-HALF PERCENT TO THESE MINERALS

Clay and Shale (used for sewer pipe or brick).*
Clay, Shale, and Slate, (used as lightweight aggregate).*

Senator BENNETT. The next witness is Mr. Morton M. Winston, executive vice president, the Oil Shale Corp.

STATEMENT OF MORTON M. WINSTON, EXECUTIVE VICE PRESIDENT, THE OIL SHALE CORP.; ACCOMPANIED BY ROBERT C. BARNARD, ATTORNEY, OF CLEARY, GOTTLIEB, STEEN & HAMILTON, WASHINGTON, D.C.

Mr. WINSTON. Thank you, Mr. Chairman.

Senator BENNETT. Before you start, did you notice one witness this morning called shale oil synthetic oil?

Mr. WINSTON. I did.

Senator BENNETT. Do you agree with him?

Mr. WINSTON. I see no reason to disagree with him. It is oil.

Senator BENNETT. It is oil, but it is not synthetic in my definition. It was not created out of unrelated chemicals. It does happen to occur in a different form in nature.

Mr. WINSTON. If I may pass the buck, Senator Bennett, I think the name was first fixed on the product by the Congress of the United States when it passed something called the Synthetic Liquid Fuel Act and we have never been able to get rid of it.

Senator CURTIS. What should it be called?

Mr. WINSTON. Crude oil.

Senator BENNETT. Or oil shale.

Senator CURTIS. I did not think it was oil from the standpoint of applying depletion.

Mr. WINSTON. That, Senator, is precisely what we are here to discuss with you.

Senator BENNETT. That is the reason he is going to testify.

It seems to me the fundamental difference is what we call crude oil or oil as it comes from a well is that it is in a rock formation in which the rock gives it up very easily and oil in shale is in a rock formation in which it requires heat and pressure for the rock to give it up.

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*Note differing rates, depending on use.

Mr. WINSTON. I think that is quite accurate, except we tend to forget that so-called conventional oil, which is found often in pools, is often not so easy to get out, and we apply heat and we apply pressure and we apply all sorts of extraordinary and costly means to acquire it.

Senator BENNETT. I will give up trying to tell you how to run your business and invite you to give us your testimony.

Mr. WINSTON. Thank you, Senator Bennett.

Members of the committee, I am accompanied, with your permission by Mr. Robert C. Barnard, who is a valued adviser to our company.

I would like, rather than read my written remarks, to request that they be accepted for the record and that I be allowed to summarize more briefly.

Senator BENNETT. They will be.

Mr. WINSTON. I would like to thank you for making time in a crowded schedule available to the Oil Shale Corp., which I represent, to present its views on the percentage depletion of shale oil.

The present law imposes what we regard as an injust discrimination against shale oil, that is, oil produced from oil shale as against oil produced from wells.

The House of Representatives has acted to remove much of the existing inequity and our purpose in being here is to ask this committee that it carry forward in this respect what the House of Representatives has done.

The commercial shale oil industry in the United States has not yet begun but it is near at hand. We and our point-venture partners, Atlantic Richfield Co., Sohio Petroleum Co., and the Cleveland Cliffs Iron Co. have, since 1954, expended more than $50 million to establish reserves and technology for commercial production. We are presently engaged in a commercial development program in the field which will cost approximately $12 million. We are doing so, because shale oil, as you have heard at length today, is needed and needed now.

Virtually unanimous projections of domestic petroleum demand and reserves foresee a sharply narrowing U.S. petroleum base between now and 1980, and, as an earlier witness said, the pattern remains the same, if it is projected to 1985.

The several hundred billion barrels of shale oil that have been estimated to be contained in the tristate area of Colorado, Utah, and Wyoming can make an important contribution. But to do so, and do so soon, arbitrary road blocks must be removed.

Under present depletion law and interpretations of that law, shale oil, which is oil and which must compete in the marketplace with oil from wells or from any other source utilized for the same purposes, is subject to two important competitive discriminations.

First, the value of shale oil is not depletable. I think that is what Senator Curtis was referring to. Only the supposed value of crushed rock is depletable, but oil from wells is depletable at the full wellhead value of the crude oil.

Second, under present law, the depletion rate for oil shale is 15 percent, a rate below that accorded oil recovered from wells.

In H.R. 13270, the House took three steps. First, it has created new provisions to provide expressly for shale oil depletion, removing it from general provisions which were never designed to deal with shale oil.

Second, it has specifically fixed the depletion rate at 15 percent.

Finally, and most important, it has established shale oil as the depletable value by fixing the point of application of the depletion rate at the first oil produced by the retorting process before any other processing.

This simple change is very important. It will give shale oil a more just competitive opportunity to find its place in oil markets. It will not diminish tax revenues. There are none now from this resource. Instead, it will produce revenues faster and in larger amounts as the unfettered industry has the opportunity to grow and make its needed contribution to oil supplies.

We are aware of only one objection that has been raised to the action taken by the House. The administration has said that shale oil should not be depletable, because it thinks the retorting process for oil shale is a manufacturing process and as such is inconsistent with the concept of depletion.

I would like to make one thing crystal clear: The retorting of oil shale is a separation process, not a manufacturing process. Only by retorting—which means in this case simply the application of heat—can the small percentage of the rock which is oil that has value, be separated from the enormous quantity of waste rock in which it is found.

It is for recovery of shale oil that production operations are conducted; and it is to shale oil first acquired by the separation process that the House finds depletion should be applicable.

Thank you.

Senator BENNETT. Thank you very much.

Any questions?

Senator CURTIS. No questions.

Senator BENNETT. I appreciate your appearance, because my State of Utah is one of those States a part of which is underlain with oil shale or oil-bearing shale.

I would just like to make one comment.

You have mentioned the fact that under some circumstances it takes the application of heat to get so-called liquid oil out of the ground. I suppose the Treasury would not say that that was a manufacturing process, and, therefore, oil thus produced could not qualify for depletion

Mr. WINSTON. It has not, to my knowledge, said so.

Senator BENNETT. I am glad this comment is in the record, because it might help us when we meet to work on the problem.

Thank you very much.

Mr. WINSTON. Thank you, sir.

(Mr. Winston's prepared statement follows:)

STATEMENT OF MORTON M. WINSTON

I am here today representing The Oil Shale Corporation, a publicly-held company, which—together with Atlantic Richfield Company, Sohio Petroleum Company, and The Cleveland-Cliffs Iron Company, as joint venturers—is now completing the development stages of the first commercial petroleum production complex from oil shale in North America.

As you know, "oil shale" is a marlstone containing a hydrocarbonaceous substance, finely distributed through the rock matrix, called "kerogen". The large oil shale deposits of Colorado, Utah and Wyoming have been estimated to contain some 800 billion barrels of petroleum reserves of good quality.

We and our joint venture partners have spent more than $50 million to establish reserves for, and the technical and economic feasibility of, commercial-production facilities for oil-shale mining, crushing, and retorting—that is, for the extraction of oil from the shale by heating. Oil-shale retorting is not a refining process; it is a separation process for the separation of the kerogen, as shale oil, from the rock by heat.

We have made this investment because we are convinced that without shale oil even the best efforts of the skillful American petroleum industry cannot keep pace with the tremendous growth of demand for liquid and gaseous petroleum and maintain safe reserve levels in the United States.

Petroleum demand is now approximately 13 million barrels per day. By 1980, it will be—conservatively—17 million barrels per day. As Director David Freeman of the President's Energy Policy Staff told the Senate Interior Committee this summer, "In view of the tremendous future demand for energy facing this nation, it would seem prudent that we develop a policy that would at least determine whether the shale resource can compete with other forms of energy. Otherwise this vast source of potential energy cannot be called upon to play its rightful role in meeting the nation's energy needs."

We and our joint venture partners are now demonstrating in field operations our conclusion that shale oil is an economic supplement to domestic petroleum supplies. But the present Internal Revenue Code is frustrating shale oil development.

Oil and gas produced from oil shale are subject to two competitive injuries in the depletion calculation under current interpretations by the Internal Revenue Service:

1. The I.R.S. ruled in 1957 that oil shale "mined solely for its kerogen content" was in the category of "all other minerals" (now section 613(b)(7) of the Code), and therefore entitled to a depletion allowance of 15%.
2. The point of application for the depletion allowance must be, according to the I.R.S., the value of the crushed oil shale rock before retorting.

Stated another way, there is no specific depletion allowance on shale *oil* under existing interpretation of the present tax code. There is only a 15% depletion on the supposed value of the unmarketable shale rock from which the oil is separated. Yet, shale oil must compete with crude oil from wells. That oil is allowed depletion at its full value at the wellhead, and the present rate is 27½%.

This depletion discrimination against shale oil production is as plain as it is indefensible. It mitigates against the flow of capital into shale oil development, and it places shale oil at a competitive disadvantage in the market place.

To remove this inequity and to encourage the development of the nation's oil shale reserves, the House Ways and Means Committee and the full House of Representatives voted to change the existing tax code as to the depletion allowance on shale oil. H.R. 13270, now pending before this Committee, sets up separate provisions for shale oil, expressly fixes the depletion rate at 15%, and fixes the point of application as the value of the oil after retorting, that is, after the separation process but before any refining.

As the Secretary of the Interior wrote in a letter to Chairman Aspinall of the House Interior Committee in 1965 commenting on a bill to apply the depletion allowance at the end of the retort:

> "Application of the depletion allowance on the gross value of crude shale oil as it comes from the retort provides a fair comparison with natural petroleum at the well-head. Crude shale oil is a product which is easily measurable and it is physically similar enough to natural petroleum to be handled in oil pipelines and sold to refineries equipped to process it further."

Oil shale retorting is not a manufacturing or refining process. It is a separation process, the only known method to separate kerogen from the shale. Shale itself has no value *per se*. It is the kerogen, which is a small part of oil shale, which has a value; and the logical point for applying depletion is after kerogen is first recovered by the separation process, and before any further processing.

This simple change in the tax code, applying shale oil depletion to the value of the oil instead of the rock, will not affect present tax receipts one iota. There is no taxable income from the shale oil industry today. To launch this industry requires large amounts of capital and entrepreneurs willing to assume the substantial risks involved, both technical and financial. If you approve the change made by H.R. 13270, it will be a significant step toward making it possible for the new industry to come alive and to grow. When that occurs, there will be taxable revenue and our vast shale oil resources will be contributing to meeting America's enormous demands for liquid fuel. This is why we urgently ask that this Committee help remove the tax discrimination against shale oil and to approve the change made by the House.

Senator BENNETT. The next witness is Mr. B. P. Huddleston, Citronelle-Mobile Gathering System Co., Inc.

STATEMENT OF B. P. HUDDLESTON, CITRONELLE-MOBILE GATHERING SYSTEM; ACCOMPANIED BY ROBERT W. WELLS, OF ARTHUR ANDERSEN & CO., NEW ORLEANS, LA.

Mr. HUDDLESTON. Mr. Chairman, members of the committee. My name is B. P. Huddleston, an independent petroleum engineer from Houston, Tex., representing the Citronelle-Mobile Gathering System, located in Mobile, Ala.

I am accompanied by Mr. Robert W. Wells of Arthur Andersen & Co., of New Orleans, La.

As a petroleum consultant these past few years, I have provided oil and gas estimates for a number of individuals, independent and major oil companies, and financial institutions.

Rather than reiterate the overall implications to the domestic industry resulting from the proposed changes in the tax law, I will limit my oral statement primarily to describing the economic effect on a producing field.

I submit to you that this case is more representative for the vast majority of individuals owning oil interests than the special case cited by the opponents of the present 27½ percent depletion allowance.

Furthermore, upon the request of your staff, I will be pleased to provide you with basic information prepared for other purposes from my files for similar analysis of the effect of changes in the depletion schedule for reserves located in New Mexico, Texas, Oklahoma, Louisiana, Arkansas, Mississppi, and other States.

Citronelle field, Alabama, has been selected as an example, not because of my association with Citronelle operators but because this field is uniquely representative of an oil reserve with diverse operating ownership. Over 500 individuals and corporations own interests in Citronelle. Major oil companies own less than 20 percent of the total operating ownership.

In addition, over 1,000 individuals receive royalty income from Citronelle production.

Citronelle field was discovered in 1955 by independent operators, and at this time is one of the most prolific fields in the southeastern United States. Through August of 1969, Cintronelle field had produced over 80 million barrels of oil. Had high-risk water flood operations been unsuccessful, this field would be uneconomical today. Rather the field is producing in excess of a half million barrels of oil per month.

Ultimate recoverable oil from this field is estimated to be in excess of 150 million barrels of oil with existing tax laws. And I might add. in my opinion, something less with the proposed changes.

Incidentally, to my knowledge, Cintronelle field is the deepest successful waterflood in the world.

The effects of the proposed changes in the tax laws on operating-interest owners in the Citronelle field were calculated for eight different cases as shown in our written statement. In the appendix, there are two complete sets of calculations, provided primarily for your staff.

The forecast of production and expenses shown therein were prepared to guide future operations in the field and do not represent special forecasts for purposes of this study. The following two cases that I will cite to you will illustrate the increase in Federal income taxes for Citronelle operators resulting from the proposed reduction of the depletion rate from 27½ percent to 20 percent. These calculations are for the 100 percent ownerships in the field, so the examples do not represent any particular individual or corporation. In fact, I believe, after the five or six largest owners, there is no one owner that owns more than 1 percent of the field. These interests are pooled so that the operators share expenses and production in proportion to their interests.

The cases in our text for the 27½ percent depletion as opposed to to 20 percent depletion show that the Federal income tax rate is increased by 19.5 percent. These were calculated for both a 25 percent and a 50 percent tax bracket, and interestingly enough, it is the same percentage increase for different tax brackets.

The actual effective depletion rate here is higher than most of the fields that I studied. For the existing 27½ percent depletion rate, the actual effective rate is 25.6 percent. If it is reduced to 20 percent, the effective rate is 19.3 percent. The vast majority of the Cintronelle owners will not have the opportunity to recover the added tax costs as do the major companies as has been described this morning.

Further, we have calculated the effect on market values of reducing the depletion allowance to 20 percent, and by elimination of the ABC transaction.

Senator CURTIS. What is an ABC transaction?

Mr. HUDDLESTON. In simple terms, "A" is the seller and he sells his property to two entities, "B" being the entity that takes the high risk on the property, and "C" being what we commonly know as the purchaser of the production payment, taking a lesser risk.

Senator CURTIS. What is the property?

Mr. HUDDLESTON. The oil property is the property sold.

Senator CURTIS. The mineral rights?

Mr. HUDDLESTON. Yes, sir, the mineral rights in the oil property. "B" would be what we think of as the conventional buyer of the property; "C" being perhaps somewhat analogous to the mortgage-holder.

In our case here, we show that the combined Federal income tax paid with the existing tax laws by the seller, the purchaser, and the purchaser of the production payment actually exceeds the Federal income tax that would be paid by the owner if the property is held throughout the economic life and subject to existing tax laws. We find in this case, with existing laws, that the market value for 100-percent ownership would be $42.5 million. However, if we lower the depletion rate from 27½ percent to 20 percent and eliminate the ABC transaction, the market value is reduced to $28 million.

These computations show that the proposed changes in the tax law would reduce Cintronelle market values by 34 percent. In all cases, our calculations show that the effective depletion allowance is always less than the maximum allowed depletion allowance, whether it be 27½ percent or 20 percent whichever appies, with or without a production payment.

Most retroactive tax legislation is discriminatory, even that legislation which can truly be called tax reform. The present bill provides for an exception to the effective date provisions relating to the creation of the production payments, if the parties have entered into a binding contract before April 22, 1969.

If two taxpayers were negotiating for an ABC sale of properties to the same purchaser, one closing his transaction on April 21 and the other closing his on April 23, the former would meet this exception while the latter would not even though the proposed tax law change governing the transaction was not presented to the House of Representatives until more than 3 months later and was not enacted until the following year.

It is strongly urged that the provisions of the bill not be effective before taxable year beginning after the date of enactment or, at the very earliest, for events coming after the date of the enactment.

Thank you.

Senator MILLER. I just want to ask a couple of questions, Mr. Chairman.

Mr. Huddleston, do you have any estimate of the amount of the percentage depletion allowance covering this Citronelle-Mobile gathering system in 1 year?

Mr. HUDDLESTON. Well, actually, I am not aware of the tax structure of the Citronelle-Mobile gathering system at all. I am here merely to represent the effects of the tax bill on the ownership in a field. I am really unaware of their specific situation.

Senator MILLER. Well, for the ownerships in the field, have you any estimate on the amount of percentage of the depletion allowance the entire ownership would comprise?

Mr. HUDDLESTON. It would be, I would estimate now, about 26 percent which I said earlier would be relatively high.

Senator MILLER. I mean in dollars.

Mr. HUDDLESTON. Yes, sir, I can find it here if you will allow me to look at the text.

Senator MILLER. Just a rough estimate; say, for 1968.

Mr. HUDDLESTON. All I have is our forecast here. It would be $2.6 million, and it would be approximately the same, by the way, for 1968.

Senator MILLER. All right. Now, do you have any estimate of how much the ownership spent during a year for exploration, for drilling costs?

Mr. HUDDLESTON. No, sir, I do not. The ownership in Citronelle is so diversified, it represents just about every type of individual from housewives to people that are actively in the exploration business, to independent companies, to people that live in the field, and I would have no idea how active they are in the exploration business.

Senator MILLER. Some of them would probably be active, and some probably would not be.

Mr. HUDDLESTON. Some of them are quite active; and for some of them, this would be the only property that they have ever participated in.

Senator MILLER. Thank you very much.

Senator CURTIS. Senator Hansen?

Senator HANSEN. I have no questions, Mr. Chairman.

Senator CURTIS. Thank you very much for your appearance.

(Mr. Huddleston's prepared statement follows:)

CASE HISTORY—THE EFFECTS OF REDUCING THE OIL DEPLETION ALLOWANCE AND THE ELIMINATION OF THE ABC TRANSACTION AS PROPOSED IN HR 13270, SECTIONS 501(a) AND (b)

(By B. P. Huddleston, P. E., Petroleum Reservoir Engineer, Houston, Tex.)

SUMMARY

This study illustrates the effect of the proposed changes in the Federal Income Tax Law relating to the percentage depletion allowance and the ABC transaction on the independent oil operator. The illustration is based on a series of cases developed from Citronelle Field, Alabama. Citronelle Field is uniquely representative of a significant oil reserve with diverse operating ownership of over 500 individuals and corporations. Major oil companies own less than 20% of the total operating interest ownership. In addition, over 1000 individuals receive royalty income from Citronelle production.

The examples herein show that the Federal income tax burden of the Citronelle operators would be increased by 19.5% if the percentage depletion rate is reduced from 27.5% to 20%. The combination of the reduction in the depletion rate and the elimination of the ABC transaction reduces the market value of the Citronelle owners' operating interests (the price that would be paid by a willing purchaser) by 34%. Independents are differentiated from major integrated oil companies since the major company can be expected to pass on these drastic effects to the ultimate consumer.

INTRODUCTION

A careful study of the proposed changes in oil and gas taxation, as described in HR 13270, Sections 501(a) and 501(b), shows that the ultimate payor will be the independent oil operators and finally the consumer. The far reaching effects of the proposed changes on the future of exploratory drilling for oil and gas reserves have been adequately described by articulate spokesmen for the petroleum industry and therefore are not treated here. Nor do we offer the oft repeated arguments for depletion or for justification for the ABC transaction. The case history described herein illustrates that the tax changes would drastically increase the tax burden of the independent oil operator and reduce the value of his properties.

CASE HISTORY

Citronelle Field, Alabama, one of the most prolific producers in the Southeastern United States, was discovered by independent oil operators in 1955 and subsequently developed primarily by independents with the drilling of over 400 wells. Only one major company made a significant contribution to the field and relatively early in the producing life this company chose to sell out rather than risk the complexity of initiating secondary recovery operations.

Through August, 1969, Citronelle Field has produced over 80 million barrels of oil. Had high-risk water flood operations been unsuccessful, the field would be uneconomical today. Rather, the field is producing approximately 500,000 barrels of oil per month. Ultimate recoverable oil from the field is estimated to be in excess of 150 million barrels with existing tax laws.

The effects of proposed changes in the tax laws on operating interest owners in Citronelle Field are shown in summary for eight different cases on Exhibit 1. Appendix A shows the complete calculations for two cases. Future project life is estimated to be 25 years. The average royalty burden is assumed to be 25% although some operators' royalty burden is considerably greater due to overriding royalties being paid to major companies.

The following two cases illustrate the increase in Federal income taxes for

Citronelle operators resulting from the proposed reduction in the depletion rate from 27.5% to 20%. These calculations are for the 100% operating ownership so that the examples may not represent any particular corporation or individual.

[Dollar amounts in thousands]

	Net revenue after FIT	Federal income tax	Actual effective depletion, percent
Case 3 [1]—27.5-percent depletion: Property is held throughout economic life subject to existing tax laws	$70,072	$27,017	25.6
Case 4 [1]—20-percent depletion: Property is held throughout economic life with statutory depletion rate reduced to 20 percent of gross income, but otherwise subject to existing tax laws	64,807	32,252	19.3

The increase in Federal income taxes is a significant 19.5 percent. The percentage increases in taxes is the same for all owners, regardless of their tax bracket. Furthermore, the vast majority of the Citronelle owners do not have the opportunity to recover the added tax cost as do the major oil companies. The 2 cases shown below illustrate the effect on the value of Citronelle oil properties considering that the depletion rate is reduced and the ABC transaction is eliminated.

	Net revenue after FIT	Federal income tax	Market value
Case 7 [1]—Property is sold to purchaser corporation in ABC transaction using $30,000,000 production payment subject to existing tax laws:			
Seller	$31,875	$10,625	
Purchaser	30,681	15,604	
Holder of production payment	4,152	4,152	
Total	66,708	30,381	$42,500
Case 4 [1]—Property is sold to purchaser corporation without ABC method and with statutory depletion rate reduced to 20 percent, otherwise subject to existing tax laws:			
Seller	21,000	7,000	
Purchaser	36,807	32,282	
Total	57,807	39,292	28,000

[1] Case numbers refer to cases listed in exhibit 1.

The ABC transaction example is based on the assumption that sixty percent of the gross revenue is dedicated to retirement of the production payment. Market value is calculated to be that sum that will provide the purchaser a rate of return of 15% on his invested capital. These computations show that proposed changes in the tax laws would reduce Citronelle market values by 34%.

In all cases, the calculations show that the effective depletion allowance is less than either 27.5% or 20% of gross revenue, whichever applies, since the deduction for allowable depletion is limited to 50% of net income computed on a property-by-property basis.

THE MAJOR COMPANY ADVANTAGE

Most major companies generally are engaged in exploration, production, transportation, refining and finally marketing of petroleum products on both a domestic and international level. In the total development and sale of products, the composite of these companies, while subject to fierce individual competition, dominate the market and can thereby expect a fair return on investment. Exhibit 2 shows that the oil companies' return on invested capital is about 12.5%, or about the mid point of the spectrum for all industries in the United States. It is reasonable to anticipate that the stockholders of the major companies will not be willing to accept an increased tax burden at the expense of lower profits.

Exhibit 3 shows the concentration of sales by oil companies. The top thirty companies represented 68% of petroleum sales in 1963 compared to 48% in 1939. Obviously, the percentage of sales contributed by smaller companies has continued to decline and the independent oil producer is being phased out of business.[1] Most of the thirty largest companies are fully integrated and therefore in a position to stabilize profits by controlling all phases of their budgets from exploration to marketing.

The point is simply that the major companies can pass any increase in taxes on to the consumer. If the price of gasoline is increased the traditional one cent per gallon, the consumer costs will be increased $800 million per year. Treasury Department estimates show that proposed change in the depletion allowance will generate $425 in tax revenues.

REMAINING OIL RESERVES IN THE UNITED STATES

In a comprehensive three phase treatment, M. King Hubbert[2] concluded that ultimate United States oil production would be approximately 160 billion barrels of which over 85 billion barrels have already been produced. Based on API estimates, cumulative discoveries to date would ultimately yield 136 billion barrels of oil leaving 24 billion barrels to be discovered. An approximate median of several other estimates place ultimate reserves at approximately 250 billion barrels. In any event, we have further produced or discovered over one half of the estimated ultimate production. Tax reform which increases materially the tax burden of an industry earning only average profits on depleting assets must be illogical by any yardstick.

The economics related to any depleting industry obviously deteriorate with continued production. The petroleum industry continues to cite irrefutable statistics to show the average well is now drilled deeper than ever before, the discovery ratio is lower, the volume of reserves for each new discovery is smaller, and finally, that only an average of 38 barrels of oil is discovered per foot of hole drilled compared to 160 barrels of oil per foot of hole drilled from 1929–35. While these data are presented, no comprehensive study by objective knowledgeable persons familiar with the petroleum industry is offered to show that the proposed tax changes will benefit the American people. At best, the argument is that the proposed changes in the tax laws may not be detrimental to our prime energy source.

If the remaining domestic reserves of 100 billion barrels are reduced by only 10 percent or 10 billion barrels by poor tax planning now, the claimed but improbable increased tax revenue will be wiped out over threefold by the value of energy lost to the United States.

EFFECTIVE DATES OF PROPOSED LEGISLATION

Most retroactive tax legislation is discriminatory, even that legislation which can be truly called "tax reform." The present tax bill was assembled and presented with such haste and is of such magnitude that the thought that it could be enacted in its present form with its many different effective dates makes one shudder. Business plans are not made overnight. Most important transactions in all industries require lengthy periods of time for negotiation and agreement, the oil and gas industry being no exception.

The present bill provides for an exception to the effective date provisions relating to the creation of production payments if the parties had entered into a binding contract before April 22, 1969. If two taxpayers were negotiating for an ABC sale of properties to the same purchaser, one closing his transaction on April 21 and the other closing his on April 23, the former would meet this exception while the latter would not, even though the proposed law change governing the transaction was not even presented to the House of Representatives until more than three months later and was not enacted until the following year.

It is strongly urged that, if enacted in its present form, the provisions of the bill not be effective before taxable years beginning after date of enactment or at the very earliest for events occurring after date of enactment.

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[1] Herbert F. Poyner, Jr., The Future of the Independent Oil Producer in the United States and its Banking Implications, thesis Southwestern Graduate School of Banking, Dallas, Texas, July, 1968.

[2] M. King Hubbert, "Degree of Advancement of Petroleum Exploration in the United States." Economics and the Petroleum Geologists (Midland West Texas Geological Society, Publication No. 66–53, 19, 1966.)

CONCLUSIONS

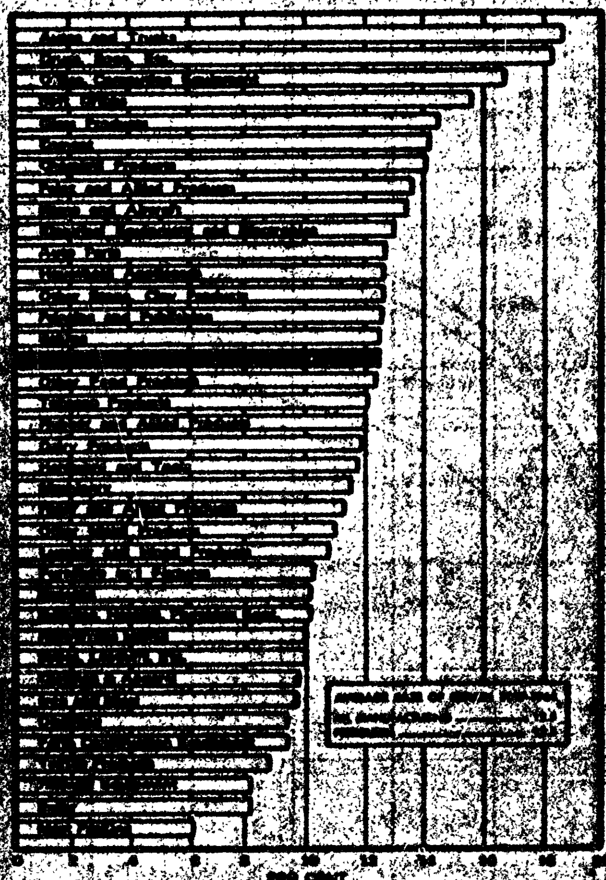
1. The reduction in the depletion allowance from 27½% to 20% will increase the tax load of the operators by 19.5% in the examples calculated herein.
2. Elimination of the ABC transaction combined with the reduction in the depletion rate will result in a loss in market value of 34% for the oil property in the attached examples. This loss will effect over 500 property owners.
3. The integrated major oil companies will probably pass any increase in taxes on to the consumer in order to maintain their present rate of return on invested capital. The independent oil operator will not have the means available to maintain such return on investment. Thus, the proposed changes in oil and gas taxation would uniquely penalize the independent oil operator.
4. The effective date of enactment of changes in the tax law should not be effected before the beginning of the first taxable year following the changes.

EFFECTS OF PROPOSED CHANGES IN FEDERAL INCOME TAX, SUMMARY OF 8 CASES, CITRONELLE FIELD, ALABAMA

[Dollar amounts in thousands]

Case No.	Federal income tax rate, percent	Maximum allowed depletion, percent	Actual effective depletion, percent	Adjusted gross income	Operating costs	Depletion allowance	Federal income tax	Future net revenue, after	Net revenue discounted at 9 percent	Production payment	Estimated market value
1	25	27.5	25.6	167,742	70,653	43,054	13,509	83,580	51,143	0	38,000
2	25	20.0	19.3	167,742	70,653	32,525	16,141	80,948	49,453	0	36,000
3	50	27.5	25.6	167,742	70,653	43,054	27,017	70,072	42,712	0	31,000
4	50	20.0	19.3	167,742	70,653	32,525	32,282	64,807	39,332	0	28,000
5	25	27.5	21.7	126,993	68,208	27,576	7,802	50,983	24,590	30,000	45,000
6	25	20.0	17.6	126,993	68,208	22,293	9,123	49,662	23,963	30,000	44,500
7	50	27.5	21.7	126,993	68,208	27,576	15,604	43,181	20,803	30,000	42,500
8	50	20.0	17.6	126,993	68,208	22,293	18,246	40,539	19,549	30,000	41,500

Notes:
1. Comparison of case 1 through 4 shows effects of reducing the depletion allowance.
2. Comparison of case 5 through 8 shows effects of reducing the depletion allowance if properties are subject to production payment.
3. Comparison of case 2 to 5 and case 4 to 7 shows combined effect of reducing the depletion allowance and eliminating the production payment.
4. Market value is equal to sum of the production payment and the amount that will yield equity 15 percent annual rate of return on invested capital.



Source: Mid-Continent Oil & Gas Association, [illegible]

EXHIBIT 2 — RATE OF RETURN ON BOOK NET ASSETS, 1947-1964

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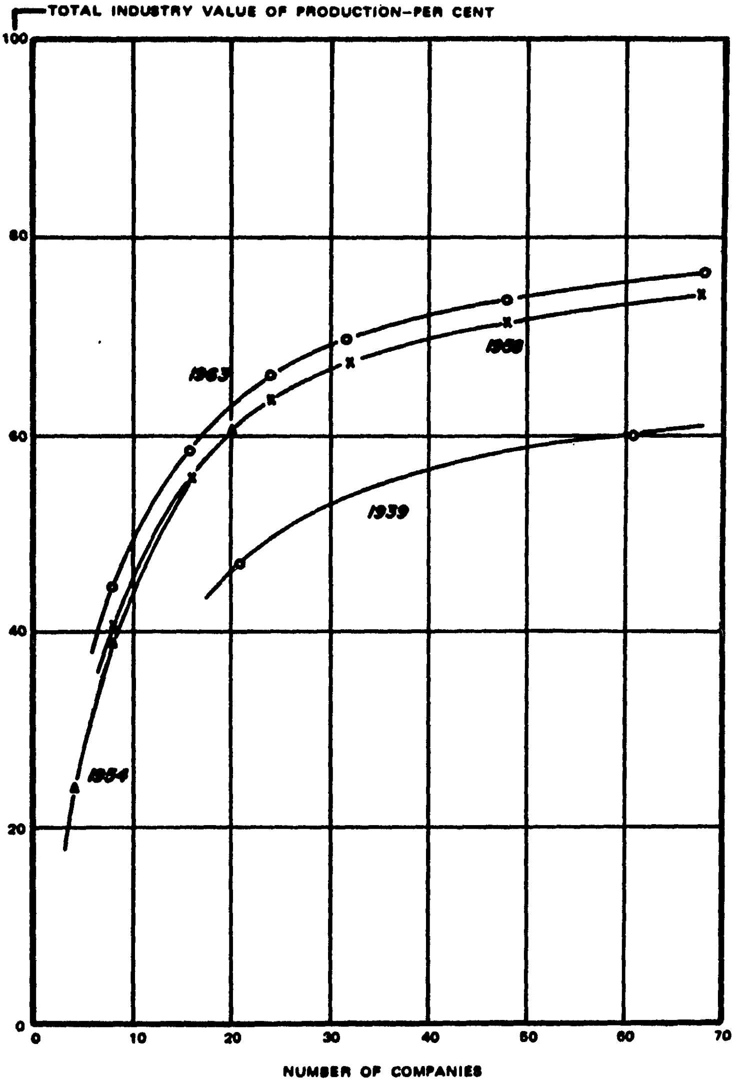


Source: U. S. Bureau of the Census

EXHIBIT 3--CONCENTRATION OF SALES IN AMERICAN PETROLEUM PRODUCTION, 1939, 1954, 1958, and 1963.

Appendix A: Example Calculations for Cases 4 and 7

EFFECT OF PROPOSED TAX CHANGES—CEITRONELLE FIELD, ALA., CASE 4

Starting date	Jan. 1, 1970
Well type	oil
Discount rate for remainder	0.2021
Number of months in last year	48
Present worth factor	0.090
Times/year PW factor and CF reinv. are compounded	2
Life of project in years	26
Lifting cost, dollars per well/month	500
Expense, fraction of gross revenue	0.0600
Operating cost (dollars/barrel)	0.500
Income tax rate	0.500

Depreciation period, in years	0
Percent 1st year tangible investment included in discount total investment	0.000
Salvage value, fraction of tangible investment	0.000
Discount rate for investment	0.000
Percent of tangible investment subject to tax credit	0.000

Areas 1 and 2 will be cleared and the results added to 1.
Undepreciated tangible investment is not added to C.F. of last year.
Depreciation is bypassed.
Cash flow is calculated without reinvestment.
Tax credit is bypassed.
Negative taxes are set to 0 and credited to next year.
Calculation will include 20 percent depletion.

Year	Production		Investments			Extra expenses	Price		Number of wells	Interest	
	Oil/cond	Gas	Tangible	Nondepletion	Depletion		Oil/con	Gas		Net	Working
1970	5,710,000	0	0	0	0	0	3.05	0.000	285	0.7500000	1.0000000
1971	6,580,000	0	0	0	0	0	3.05	.000	285	.7500000	1.0000000
1972	6,390,000	0	0	0	0	0	3.05	.000	285	.7500000	1.0000000
1973	6,610,000	0	0	0	0	0	3.05	.000	280	.7500000	1.0000000
1974	5,280,000	0	0	0	0	0	3.05	.000	275	.7500000	1.0000000
1975	4,860,000	0	0	0	0	0	3.05	.000	265	.7500000	1.0000000
1976	4,510,000	0	0	0	0	0	3.05	.000	260	.7500000	1.0000000
1977	4,280,000	0	0	0	0	0	3.05	.000	255	.7500000	1.0000000
1978	4,020,000	0	0	0	0	0	3.05	.000	250	.7500000	1.0000000
1979	3,680,000	0	0	0	0	0	3.05	.000	245	.7500000	1.0000000
1980	3,250,000	0	0	0	0	0	3.05	.000	240	.7500000	1.0000000
1981	2,710,000	0	0	0	0	0	3.05	.000	235	.7500000	1.0000000
1982	2,330,000	0	0	0	0	0	3.05	.000	230	.7500000	1.0000000
1983	2,010,000	0	0	0	0	0	3.05	.000	225	.7500000	1.0000000
1984	1,750,000	0	0	0	0	0	3.05	.000	220	.7500000	1.0000000
1985	1,520,000	0	0	0	0	0	3.05	.000	215	.7500000	1.0000000
1986	1,370,000	0	0	0	0	0	3.05	.000	210	.7500000	1.0000000
1987	1,220,000	0	0	0	0	0	3.05	.000	205	.7500000	1.0000000
1988	1,100,000	0	0	0	0	0	3.05	.000	200	.7500000	1.0000000
1989	980,000	0	0	0	0	0	3.05	.000	190	.7500000	1.0000000
1990	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1991	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1992	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1993	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1994	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1995	3,170,000	0	0	0	0	0	3.05	.000	165	.7500000	1.0000000

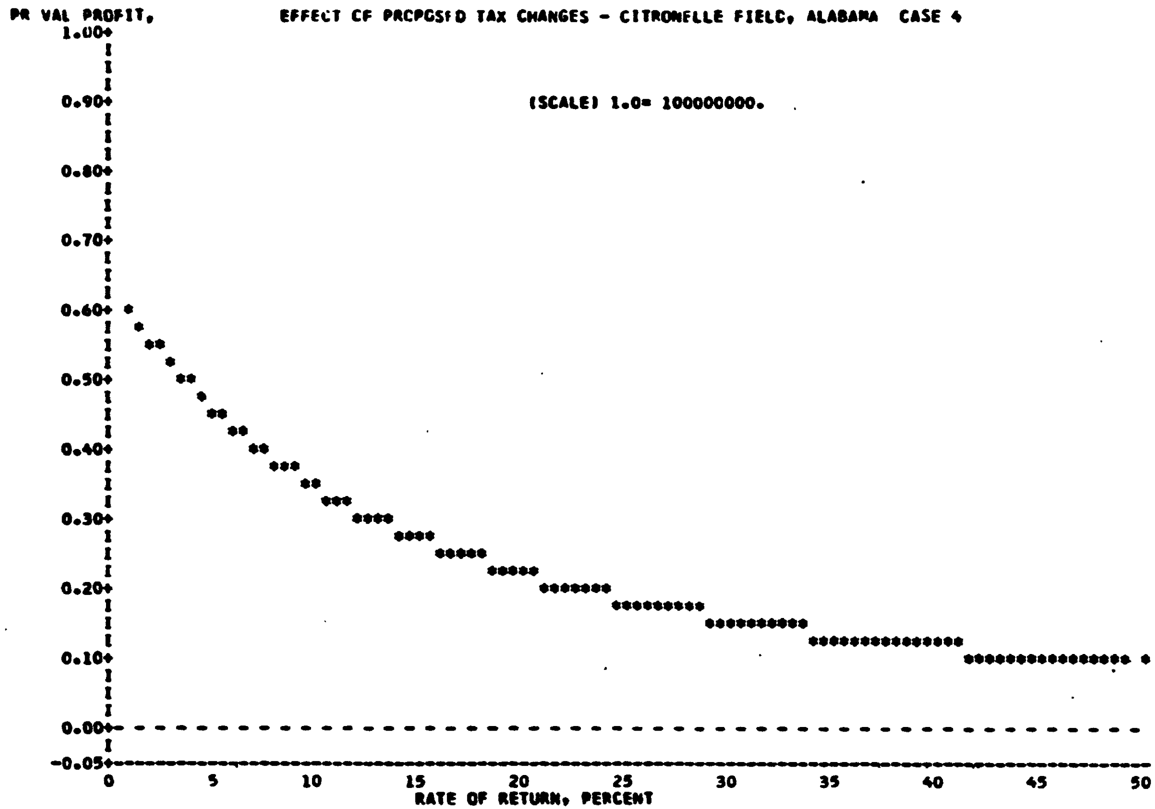
EFFECT OF PROPOSED TAX CHANGES, CITRONELLE FIELD, ALABAMA, CASE 4

Year	Gross production		Net production		Production payment			
	Oil/cond (barrels)	Gas (million cubic feet)	Oil/cond (barrels)	Gas (million cubic feet)	Oil/cond (barrels)	Gas (million cubic feet)	Actual (dollars)	Interest (dollars)
1970	5,710,000	0	4,282,500	0	0	0	0	0
1971	6,580,000	0	4,934,000	0	0	0	0	0
1972	6,390,000	0	4,792,500	0	0	0	0	0
1973	6,610,000	0	4,957,500	0	0	0	0	0
1974	5,280,000	0	3,960,000	0	0	0	0	0
1975	4,860,000	0	3,645,000	0	0	0	0	0
1976	4,510,000	0	3,382,500	0	0	0	0	0
1977	4,280,000	0	3,210,000	0	0	0	0	0
1978	4,020,000	0	3,015,000	0	0	0	0	0
1979	3,680,000	0	2,760,000	0	0	0	0	0
1980	3,250,000	0	2,437,500	0	0	0	0	0
1981	2,710,000	0	2,032,500	0	0	0	0	0
1982	2,330,000	0	1,747,500	0	0	0	0	0
1983	2,010,000	0	1,507,500	0	0	0	0	0
1984	1,750,000	0	1,312,500	0	0	0	0	0
1985	1,520,000	0	1,140,000	0	0	0	0	0
1986	1,370,000	0	1,027,500	0	0	0	0	0
1987	1,220,000	0	915,000	0	0	0	0	0
1988	1,100,000	0	825,000	0	0	0	0	0
1989	980,000	0	735,000	0	0	0	0	0
1990	0	0	0	0	0	0	0	0
1991	0	0	0	0	0	0	0	0
1992	0	0	0	0	0	0	0	0
1993	0	0	0	0	0	0	0	0
1994	0	0	0	0	0	0	0	0
Subtotal	70,160,000	0	52,620,000	0	0	0	0	0
Remittance	3,170,000	0	2,377,500	0	0	0	0	0
Total	73,330,000	0	54,997,500	0	0	0	0	0

Year	Expenses-costs: Lifting	Revenue	Operating	Extra	Total	Investment data: Tangible	Intangible	Depreciation
1970	1,710,000	783,697	2,141,250	0	4,634,947	0	0	0
1971	1,710,000	903,105	2,467,500	0	5,080,605	0	0	0
1972	1,710,000	877,027	2,396,250	0	4,983,277	0	0	0
1973	1,680,000	907,222	2,478,750	0	5,065,972	0	0	0
1974	1,650,000	724,680	1,980,000	0	4,354,680	0	0	0
1975	1,590,000	667,035	1,822,500	0	4,079,535	0	0	0
1976	1,560,000	618,997	1,691,250	0	3,870,247	0	0	0
1977	1,530,000	587,430	1,605,000	0	3,722,430	0	0	0
1978	1,500,000	551,745	1,507,500	0	2,559,245	0	0	0
1979	1,470,000	505,080	1,380,000	0	3,355,080	0	0	0
1980	1,440,000	446,062	1,218,750	0	3,104,812	0	0	0
1981	1,410,000	371,947	1,016,250	0	2,798,197	0	0	0
1982	1,380,000	319,792	873,750	0	2,573,542	0	0	0
1983	1,350,000	275,872	753,750	0	2,379,622	0	0	0
1984	1,320,000	240,187	656,250	0	2,216,437	0	0	0
1985	1,290,000	208,620	570,000	0	2,068,620	0	0	0
1986	1,260,000	188,032	513,750	0	1,961,782	0	0	0
1987	1,230,000	167,445	457,500	0	1,854,945	0	0	0
1988	1,200,000	150,975	412,500	0	1,763,475	0	0	0
1989	1,140,000	134,505	367,500	0	1,642,005	0	0	0
1990	0	0	0	0	0	0	0	0
1991	0	0	0	0	0	0	0	0
1992	0	0	0	0	0	0	0	0
1993	0	0	0	0	0	0	0	0
1994	0	0	0	0	0	0	0	0
Subtotal	29,130,000	9,629,455	26,310,000	0	65,069,455	0	0	0
Remittance	3,960,000	435,082	1,188,750	0	5,583,832	0	0	0
Total	33,090,000	10,064,537	27,498,750	0	70,653,287	0	0	0

Year	Depletion taken	Income tax payment	Tax credit taken	Adjusted gross income	Net cash flow: Annual	Net cash flow: Cumulative	Reinvested cash flow: Annual	Reinvested cash flow: Cumulative
								0
1970	2,612,325	2,907,176	0	13,061,625	5,519,501	5,519,501	0	0
1971	3,010,350	3,480,397	0	15,051,750	6,490,747	12,010,249	0	0
1972	2,923,425	3,355,211	0	14,617,125	6,278,636	18,288,885	0	0
1973	3,024,075	3,515,164	0	15,120,375	6,539,239	24,828,124	0	0
1974	2,415,600	2,653,860	0	12,078,000	5,069,459	29,897,584	0	0
1975	2,223,450	2,407,132	0	11,117,250	4,630,582	34,528,167	0	0
1976	2,063,325	2,191,526	0	10,316,625	4,254,851	38,783,018	0	0
1977	1,958,100	2,054,985	0	9,790,500	4,013,085	42,796,103	0	0
1978	1,839,150	1,898,677	0	9,195,750	3,737,827	46,533,931	0	0
1979	1,683,600	1,689,660	0	8,418,000	3,373,260	49,907,191	0	0
1980	1,486,875	1,421,344	0	7,434,375	2,908,219	52,815,410	0	0
1981	1,239,825	1,080,551	0	6,199,125	2,320,376	55,135,786	0	0
1982	1,065,975	845,179	0	5,329,875	1,911,154	57,046,940	0	0
1983	919,575	649,339	0	4,597,875	1,568,914	58,615,854	0	0
1984	800,625	493,031	0	4,003,125	1,293,657	59,909,511	0	0
1985	695,400	356,490	0	3,477,000	1,051,890	60,961,401	0	0
1986	586,046	293,023	0	3,133,875	879,070	61,840,471	0	0
1987	467,902	233,951	0	2,790,750	701,854	62,542,325	0	0
1988	376,387	188,194	0	2,516,250	564,581	63,106,906	0	0
1989	299,872	149,936	0	2,241,750	449,809	63,556,715	0	0
1990	0	0	0	0	0	63,556,715	0	0
1991	0	0	0	0	0	63,556,715	0	0
1992	0	0	0	0	0	63,556,715	0	0
1993	0	0	0	0	0	63,556,715	0	0
1994	0	0	0	0	0	63,556,715	0	0
Subtotal	31,691,881	31,864,829	0	167,742,374	63,556,715		0	
Remittance	833,771	416,886	0	7,251,375	1,250,657	64,807,372	0	0
Total	32,525,652	32,281,715	0	167,742,374	64,807,372		0	

Year	Processing water factor	Present worth of: Adjusted gross income	Present worth of: Net income	Present worth of: Net cash flow	Discounted total investment	Present worth profit: Annual	Present worth profit: Cumulative	Rate of return
1970	0.95705	12,500,670	8,064,779	5,282,456	0	5,282,456	5,282,456	
1971	.87650	13,192,979	8,739,788	5,689,192	0	5,689,192	10,971,648	
1972	.80264	11,732,356	7,732,556	5,039,513	0	5,039,513	16,011,162	
1973	.73500	11,113,561	7,390,043	4,806,378	0	4,806,378	20,817,540	
1974	.67306	8,129,300	5,198,309	3,412,084	0	3,412,084	24,229,625	
1975	.61634	6,852,087	4,337,677	2,854,047	0	2,854,047	27,083,672	
1976	.56440	5,822,783	3,638,385	2,401,471	0	2,401,471	29,485,143	
1977	.51684	5,060,171	3,136,252	2,074,143	0	2,074,143	31,559,287	
1978	.47329	4,352,261	2,667,704	1,769,078	0	1,769,078	33,328,365	
1979	.43340	3,648,414	2,194,301	1,461,992	0	1,461,992	34,790,357	
1980	.39688	2,950,578	1,718,330	1,154,223	0	1,154,223	34,944,580	
1981	.36343	2,252,996	1,236,025	843,312	0	843,312	36,787,892	
1982	.33281	1,773,840	917,338	636,053	0	636,053	37,423,945	
1983	.30476	1,401,270	676,046	478,150	0	478,150	37,902,095	
1984	.27908	1,117,201	498,633	361,037	0	361,037	38,263,132	
1985	.25556	888,596	359,931	268,825	0	268,825	38,531,957	
1986	.23402	733,413	274,302	205,727	0	205,727	38,737,684	
1987	.21430	598,075	200,549	150,412	0	150,412	38,888,096	
1988	.19624	493,805	147,729	110,797	0	110,797	38,998,893	
1989	.17970	402,862	10,7779	80,835	0	80,835	39,079,728	
1990	.16456	0	0	0	0	0	39,079,728	
1991	.15069	0	0	0	0	0	39,079,728	
1992	.13799	0	0	0	0	0	39,079,728	
1993	.12636	0	0	0	0	0	39,079,728	
1994	.11571	0	0	0	0	0	39,079,728	
Subtotal		95,017,223	59,236,461	39,079,728	0	39,079,728		
Remittance	.20210	1,465,502	337,010	252,758	0	252,758	39,332,486	
Total		96,482,726	59,573,471	39,332,486	0	39,332,486		



Appendix A - Exhibit 1 - Page 6 of 6

EFFECT OF PROPOSED TAX CHANGES—CITRONELLE FIELD, ALA, CASE 7

Starting date	Jan. 1, 1970
Well type	oil
Discount rate for remainder	0.2021
Number of months in last year	48
Present worth factor	0.090
Times/year PW factor and CF reinv. are compounded	2
Life of project in years	26
Lifting cost, dollars per well/month	500
Expense, fraction of gross revenue	0.0600
Operating cost (dollars per barrel)	0.500
Income tax rate	0.500
Depreciation period, in years	0
Percent 1st year tangible inventory included in discount total inventory	0.000
Discount rate for investment	0.000
Salvage value, fraction of tangible investment	0.000
Production payment	30,000,000.
Interest rate on production payment	0.090
Percentage of production applied to payment	0.600
Percent of tangible inventory subject to tax credit	0.000

Areas 1 and 2 will be cleared and the results added to 1.
Unpdepreciated tangible inventory is not added to C.F. of last year.
Depreciation is bypassed.
Cash flow is calculated without reinvestment.
Tax credit is bypassed.
Negative taxes are set to 0 and credited to next year.
Calculation will include 27.5 percent depletion.

Year	Production		Investments		Depletion	Extra expenses	Price		Number of wells	Interest	
	Oil cond	Gas	Tangible	nondepletion			Oil/con	Gas		Net	Working
1970	5,710,000	0	0	0	0	0	3.05	0.000	285	0.7500000	1.0000000
1971	6,580,000	0	0	0	0	0	3.05	.000	285	.7500000	1.0000000
1972	6,390,000	0	0	0	0	0	3.05	.000	285	.7500000	1.0000000
1973	6,610,000	0	0	0	0	0	3.05	.000	280	.7500000	1.0000000
1974	5,280,000	0	0	0	0	0	3.05	.000	275	.7500000	1.0000000
1975	4,860,000	0	0	0	0	0	3.05	.000	265	.7500000	1.0000000
1976	4,510,000	0	0	0	0	0	3.05	.000	260	.7500000	1.0000000
1977	4,280,000	0	0	0	0	0	3.05	.000	255	.7500000	1.0000000
1978	4,020,000	0	0	0	0	0	3.05	.000	250	.7500000	1.0000000
1979	3,680,000	0	0	0	0	0	3.05	.000	245	.7500000	1.0000000
1980	3,250,000	0	0	0	0	0	3.05	.000	240	.7500000	1.0000000
1981	2,710,000	0	0	0	0	0	3.05	.000	235	.7500000	1.0000000
1982	2,330,000	0	0	0	0	0	3.05	.000	230	.7500000	1.0000000
1983	2,010,000	0	0	0	0	0	3.05	.000	225	.7500000	1.0000000
1984	1,750,000	0	0	0	0	0	3.05	.000	220	.7500000	1.0000000
1985	1,520,000	0	0	0	0	0	3.05	.000	215	.7500000	1.0000000
1986	1,370,000	0	0	0	0	0	3.05	.000	210	.7500000	1.0000000
1987	1,220,000	0	0	0	0	0	3.05	.000	205	.7500000	1.0000000
1988	1,100,000	0	0	0	0	0	3.05	.000	200	.7500000	1.0000000
1989	980,000	0	0	0	0	0	3.05	.000	190	.7500000	1.0000000
1990	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1991	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1992	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1993	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1994	0	0	0	0	0	0	3.05	.000	0	.7500000	1.0000000
1995	3,170,000	0	0	0	0	0	3.05	.000	165	.7500000	1.0000000

EFFECT OF PROPOSED TAX CHANGES, CITRONELLE FIELD, ALABAMA, CASE 7

Year	Gross production		Net production		Production payment			
	Oil/cond (barrels)	Gas (million cubic feet)	Oil/cond (barrels)	Gas (million cubic feet)	Oil/cond (barrels)	Gas (million cubic feet)	Actual (dollars)	Interest (dollars)
1970	5,710,000	0	4,282,500	0	2,569,500	0	7,366,756	2,700,000
1971	6,580,000	0	4,935,000	0	2,961,000	0	8,489,187	2,279,991
1972	6,390,000	0	4,792,500	0	2,875,500	0	8,244,058	1,721,164
1973	6,610,000	0	4,957,500	0	2,974,500	0	8,527,891	1,134,103
1974	5,280,000	0	3,960,000	0	1,979,780	0	5,676,029	468,663
1975	4,860,000	0	3,645,000	0	0	0	0	0
1976	4,510,000	0	3,382,500	0	0	0	0	0
1977	4,280,000	0	3,210,000	0	0	0	0	0
1978	4,020,000	0	3,015,000	0	0	0	0	0
1979	3,680,000	0	2,760,000	0	0	0	0	0
1980	3,250,000	0	2,437,500	0	0	0	0	0
1981	2,710,000	0	2,032,500	0	0	0	0	0
1982	2,330,000	0	1,747,500	0	0	0	0	0
1983	2,010,000	0	1,507,500	0	0	0	0	0
1984	1,750,000	0	1,312,500	0	0	0	0	0
1985	1,520,000	0	1,140,000	0	0	0	0	0
1986	1,370,000	0	1,027,500	0	0	0	0	0
1987	1,220,000	0	915,000	0	0	0	0	0
1988	1,100,000	0	825,000	0	0	0	0	0
1989	980,000	0	735,000	0	0	0	0	0
1990	0	0	0	0	0	0	0	0
1991	0	0	0	0	0	0	0	0
1992	0	0	0	0	0	0	0	0
1993	0	0	0	0	0	0	0	0
1994	0	0	0	0	0	0	0	0
Subtotal	70,160,000	0	52,620,000	0	13,360,280	0	38,303,923	8,303,923
Remittance	3,170,000	0	2,377,500	0	0	0	0	0
Total	73,330,000	0	54,997,500	0	13,360,280	0	38,303,923	8,303,923

Year	Expenses-costs					Investment data		
	Lifting	Revenue	Operating	Extra	Total	Tangible	Intangible	Depreciation
1970	$1,710,000	$313,479	$2,141,250	0	$4,164,729	0	0	0
1971	1,710,000	361,242	2,467,500	0	4,538,742	0	0	0
1972	1,710,000	350,811	2,396,250	0	4,457,061	0	0	0
1973	1,680,000	362,889	2,478,750	0	4,521,639	0	0	0
1974	1,650,000	362,380	1,980,000	0	3,992,380	0	0	0
1975	1,590,000	667,035	1,822,500	0	4,079,535	0	0	0
1976	1,560,000	618,997	1,691,250	0	3,870,247	0	0	0
1977	1,440,000	587,430	1,605,000	0	3,722,430	0	0	0
1978	1,500,000	551,745	1,507,500	0	3,559,245	0	0	0
1979	1,470,000	505,080	1,380,000	0	3,355,080	0	0	0
1980	1,440,000	446,062	1,218,750	0	3,104,812	0	0	0
1981	1,410,000	371,947	1,016,250	0	2,798,197	0	0	0
1982	1,380,000	319,792	873,750	0	2,573,542	0	0	0
1983	1,350,000	275,872	753,750	0	2,379,622	0	0	0
1984	1,320,000	240,187	656,250	0	2,216,437	0	0	0
1985	1,290,000	208,620	570,000	0	2,068,620	0	0	0
1986	1,260,000	188,032	513,750	0	1,961,782	0	0	0
1987	1,230,000	167,445	457,500	0	1,854,945	0	0	0
1988	1,200,000	150,975	412,500	0	1,763,475	0	0	0
1989	1,140,000	134,505	367,500	0	1,642,005	0	0	0
1990	0	0	0	0	0	0	0	0
1991	0	0	0	0	0	0	0	0
1992	0	0	0	0	0	0	0	0
1993	0	0	0	0	0	0	0	0
1994	0	0	0	0	0	0	0	0
Subtotal	29,130,000	7,184,525	26,310,000	0	62,624,525	0	0	0
Remittance	3,960,000	435,082	1,188,750	0	5,583,832	0	0	0
Total	33,090,000	7,619,607	27,498,750	0	68,208,357	0	0	0

Year	Depletion taken	Income tax payment	Tax credit taken	Adjusted gross income	Net cash flow		Reinvested cash flow	
					Annual	Cumulative	Annual	Cumulative
1970	529,960	264,980	0	5,224,650	794,941	794,941	0	0
1971	740,979	370,489	0	6,020,700	1,111,468	1,906,409	0	0
1972	694,894	347,447	0	5,846,850	1,042,341	2,948,751	0	0
1973	763,255	381,628	0	6,048,150	1,144,882	4,093,634	0	0
1974	1,023,645	511,823	0	6,039,670	1,535,467	5,629,102	0	0
1975	3,057,243	1,990,235	0	1,117,250	5,047,479	1,0676,581	0	0
1976	2,837,071	1,804,653	0	10,316,625	4,641,724	15,318,306	0	0
1977	2,692,387	1,687,841	0	9,790,500	4,380,228	19,698,535	0	0
1978	2,528,831	1,553,836	0	9,195,750	4,082,668	23,781,203	0	0
1979	2,313,950	1,373,985	0	8,418,000	3,686,935	27,470,138	0	0
1980	2,044,453	1,142,554	0	7,434,375	3,187,008	30,657,146	0	0
1981	1,700,463	850,232	0	6,199,125	2,550,695	33,207,842	0	0
1982	1,378,166	689,083	0	5,329,875	2,067,250	35,275,092	0	0
1983	1,109,126	554,563	0	4,597,875	1,663,690	36,938,782	0	0
1984	893,344	446,672	0	4,003,125	1,340,016	38,278,798	0	0
1985	704,190	352,095	0	3,477,000	1,056,285	39,335,083	0	0
1986	586,046	293,023	0	3,133,875	879,070	40,214,153	0	0
1987	467,902	233,951	0	2,790,750	701,854	40,916,007	0	0
1988	376,387	188,194	0	2,516,250	564,581	41,480,588	0	0
1989	299,872	149,936	0	2,241,750	449,809	41,930,397	0	0
1990	0	0	0	0	0	41,930,397	0	0
1991	0	0	0	0	0	41,930,397	0	0
1992	0	0	0	0	0	41,930,397	0	0
1993	0	0	0	0	0	41,930,397	0	0
1994	0	0	0	0	0	41,930,397	0	0
Subtotal	26,743,168	15,187,222	0	126,993,520	41,930,397		0	
Remittance	833,771	416,886	0	7,251,375	1,250,657	43,181,054	0	0
Total	27,576,939	15,604,108	0	126,993,520	43,181,054		0	

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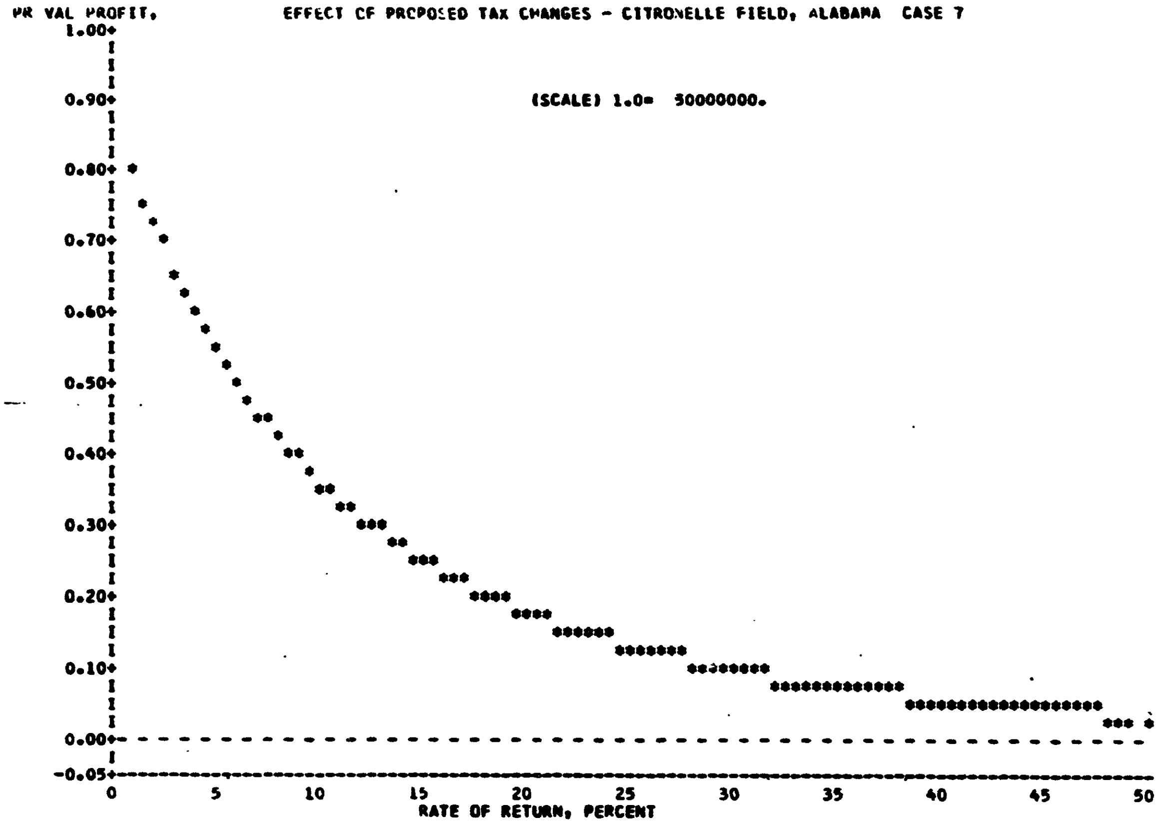
Year	Processing water factor	Present worth of: Adjusted gross income	Present worth of: Net income	Present worth of: Net cash flow	Discounted total investment	Present worth profit: Annual	Present worth profit: Cumulative	Rate of return
1970	0.85705	5,000,268	1,014,400	760,810	0	760,801	760,801	
1971	.87650	5,277,191	1,298,848	974,211	0	974,211	1,735,012	
1972	.80264	4,692,942	1,115,506	836,630	0	836,630	2,571,642	
1973	.73500	4,445,424	1,121,994	841,496	0	841,496	3,413,138	
1974	.67306	4,065,101	1,377,963	1,033,472	0	1,033,472	4,446,610	
1975	.61634	6,852,087	4,337,677	3,111,000	0	3,111,000	7,557,610	
1976	.56440	5,822,783	3,638,385	2,619,825	0	2,619,825	10,177,436	
1977	.51684	5,060,171	3,136,252	2,265,899	0	2,263,899	12,441,336	
1978	.47329	4,352,261	2,667,704	1,932,288	0	1,932,288	14,373,624	
1979	.43340	3,648,414	2,194,301	1,598,807	0	1,598,807	15,972,431	
1980	.39688	2,950,578	1,718,330	1,264,869	0	1,264,869	17,237,301	
1981	.36343	2,252,996	1,236,025	927,019	0	927,019	18,164,320	
1982	.33281	1,773,840	917,338	688,003	0	688,003	18,852,323	
1983	.30476	1,401,270	676,046	507,034	0	507,034	19,359,357	
1984	.27908	1,117,201	498,633	373,975	0	373,975	19,733,332	
1985	.25556	888,596	359,931	269,948	0	269,948	20,003,280	
1986	.23402	733,413	274,302	205,727	0	205,727	20,209,007	
1987	.21430	598,075	200,549	150,412	0	150,412	20,359,419	
1988	.19624	493,805	147,729	110,797	0	110,797	20,470,216	
1989	.17970	402,862	107,779	80,835	0	80,835	20,551,051	
1990	.16456	0	0	0	0	0	20,551,051	
1991	.15069	0	0	0	0	0	20,551,051	
1992	.13799	0	0	0	0	0	20,551,051	
1993	.12636	0	0	0	0	0	20,551,051	
1994	.11571	0	0	0	0	0	20,551,051	
Subtotal		61,829,284	28,039,797	20,551,051	0	29,551,051		
Remittance	.20210	1,465,502	337,010	252,758	0	252,758	20,803,809	
Total		63,294,787	28,376,807	20,803,809	0	20,803,809		

Appendix A - Exhibit 2 - Page 6 of 6



Senator CURTIS. Mr. Harold Rogers, North Texas Oil & Gas Association.

STATEMENT OF HAROLD D. ROGERS, ATTORNEY, OF SHERRILL, PACE & ROGERS, WICHITA FALLS, TEX., REPRESENTING NORTH TEXAS OIL & GAS ASSOCIATION, WICHITA FALLS, TEX.

Mr. ROGERS. Mr. Chairman and members of the Senate Finance Committee, my name is Harold D. Rogers and I am an attorney practicing law in the law firm of Sherrill, Pace & Rogers, Wichita Falls, Tex. I am here representing the North Texas Oil & Gas Association, Wichita Falls, Tex.

I appreciate the opportunity to appear before you to present to you the position that section 501(b) of the proposed Tax Reform Act of 1969 is unconstitutional. The position stated herein has the approval and concurrence of Mr. Leland Fiske, chairman of the natural resources committee, taxation section, American Bar Association.

In addition—this is not in my transcript—Mr. Isidore Specks, who is an attorney and an accountant in Dallas, Tex., assisted in the preparation of this testimony, and Mr. Specks, prior to 1963, when he left the Government service, had spent 44 years as an attorney in the appellate division in the Dallas region, and, as such, he was known pretty much as "Mr. Internal Revenue" in the Dallas region of Internal Revenue. He, of course, concurs in the position taken here.

Senator CURTIS. What provision is it that you attack the constitutionality of?

Mr. ROGERS. It is the provisions relating to carved-out production payments and retained production payments. I am going to state right now, the provisions.

Section 501(b) in title V of the Tax Reform Act of 1969—H.R. 13270—provides that income from mineral production payments—whether carved-out or retained—be taxed to the owner of the mineral property, not to the owner of the production payment.

Proposed section 636(a) reads as follows with respect to carved-out production payments:

> A production payment carved out of mineral property shall be treated as if it were a mortgage loan on the property and shall not qualify as an economic interest in the mineral property.

Proposed section 636(b) reads as follows with respect to retained production payments:

> A production payment retained on the sale of a mineral property shall be treated as if it were a purchase money mortgage loan and shall not qualify as an economic interest in the mineral property.

Senator CURTIS. Tell us what your language "carved out" is.

Mr. ROGERS. Let me give you an example in connection with a reserved or retained production payment.

A sells producing mineral property to B for $10,000, reserving unto himself a $15,000 production payment, payable out of 50 percent of the gross sales price of all of the oil produced from the mineral property, so that B has purchased the mineral property but A has reserved a production payment out of that mineral property, so A then owns the production payment and B owns the mineral property.

Senator CURTIS. Production payment is the sale of the oil when you start to produce; is that right?

Mr. ROGERS. That is right.

Senator CURTIS. So, he gets $10,000 cash and he is to get $15,000 as he starts to pump oil; is that what you mean?

Mr. ROGERS. That is correct.

He gets that out of 50 percent of the oil sales out of the ground; 50 percent of the oil sales would go to B.

Senator CURTIS. Out of the $15,000.

Mr. ROGERS. Right.

Senator CURTIS. Now, what is it you call that?

Mr. ROGERS. That is a reserved production payment.

Senator CURTIS. What is this "carved out" expression?

Mr. ROGERS. A carved-out production payment would be where A sells a production payment to B in the amount of $25,000, for example, and B then owns an undivided 50 percent of the oil in the ground until he has recovered $25,000 out of oil sales, and A owns the mineral interest. So, in that example A owns the mineral interest, B owns the production payment and is entitled to receive 50 percent of the oil sales until he has recovered $25,000.

Senator CURTIS. In that case, A does not sell the property.

Mr. ROGERS. He sells an undivided 50 percent of the oil.

Senator CURTIS. As it is produced?

Mr. ROGERS. Until $25,000 is recovered; so, he actually gets $25,000 in cash from B, you see, and then B owns an undivided 50 percent of the oil in the ground, until he recovers his $25,000.

Senator CURTIS. And A owns it afterward?

Mr. ROGERS. That is right. A owns it all the way through. However, during the payout period of the production payment he only owns 50 percent of the oil.

Senator CURTIS. What did the House do?

Mr. ROGERS. I was going to explain that next.

Senator MILLER. Excuse me. May I ask a question at that point?

What is the difference between that and somebody who owns a rental property and he retains the basic ownership of the rental property but he sells to B the right to the rental income for a 10-year period?

Mr. ROGERS. No difference. In fact, later on in my testimony, I am going to compare those as being exactly the same, Senator.

Senator FANNIN. What incentive is there for him to put up this money?

He gets back more than $15,000. You just stated he gets back $15,000. He gets a return on that $15,000, does he not?

Mr. ROGERS. Yes.

Senator CURTIS. He may pay less than the $25,000.

Mr. ROGERS. The production payment owner will get $25,000 plus an amount equal to, let us say, 8 percent interest per annum.

Senator FANNIN. That is what I am talking about.

Mr. ROGERS. That is right.

Senator FANNIN. In other words, he is not just getting his money back because he would have no incentive whatsoever.

Mr. ROGERS. That is right. He will have a profit.

Senator FANNIN. An undetermined profit.

Mr. ROGERS. Yes, depending on the life of the property, that is right.

QUESTION PRESENTED

Whether Congress would be violating the U.S. Constitution by enacting legislation which would require taxpayer B in the following two examples to include in his taxable income the amounts received by taxpayer A from a production payment owned by A—this example is the same example that I gave Senator Curtis.

"A", the owner of a producing oil lease (sometimes called mineral property or working interest) sells the lease to "B" for $10,000 reserving unto himself a $15,000 production payment (plus a sum equal to interest at the rate of 8 percent per annum) payable out of 50 percent of the gross sales price of all of the oil produced from the mineral property.

Now, the House bill which relates to retained production payments proposes to tax to "B" the $15,000 received by "A" even though "A" owns the production payment and will receive the entire $15,000 as paid from oil sales made from the lease.

Example 2. "B"—and I have characterized it in both examples as "B" owning the mineral property. "B", the owner of a producing oil lease, sell a $25,000 production payment to "A". The production payment is payable out of 50 percent of the gross sales price of all the oil sold from the lease plus a sum equal to interest on said $25,000 at 8 percent per annum.

In that example, the House bill relating to carved-out production payments proposes to tax to "B" the $25,000 as received by "A" even though "A" owns the production payment and will receive the entire $25,000 as paid from oil sales made from the lease.

Law and Discussion: The proposed law as set forth in section 501 (b) to tax the income of "A" to "B" as outlined in examples "1" and "2" above is clearly unconstitutional. The Supreme Court held in *Hoeper* v. *Tax Commission of Wisconsin* (1931), 284 U.S., 206 that due process is denied where one person is taxed upon the income from the property owned by another. In that case the State of Wisconsin had attempted by statute to tax a husband on income earned by his wife from her separate property. The U.S. Supreme Court held that an attempt by the State of Wisconsin to measure tax on a person's property or income by reference to another's property or income is contrary to the due process clause of the 14th amendment. The Court stated at page 215:

"That which is not in fact the taxpayer's income cannot be made such by calling it income."

Proposed section 501(b) as quoted above constitutes a denial of due process under the fifth amendment to the Constitution. These proposals attempts to tax the income of one person to another person. In example "1" above and on the chart "A" is the owner of the production payment since he retained the production payment from his conveyance to "B" and he is the only person entitled to receive the income from the production payment. "B" has no legal rights in the production payment nor does he have any command over the income from the property.

It has been settled law for many years that property rights depend upon the law of the State where the property is located. The Supreme Court has held that State law controls in determining the nature of the legal interest that a taxpayer has in property. *Tyler* v. *United States*, (1930), 281 U.S. 497; *Blair* v. *Commissioner*, (1937), 300 U.S. 5. The various States have unanimously held that the owner of a production payment is the owner of a vested property right. Furthermore, the Supreme Court has held that the owner of a production payment, not the owner of the mineral property, is taxable on the amounts received from the production payment. *Thomas* v. *Perkins*, (1937), 301 U.S. 655.

The proposed statute, as passed by the House, is unconstitutional because it taxes to one person the income from property owned by another person. Moreover, the proposed statute attempts to create a mortgage when no mortgage exists. In example "1" above, the proposed statute provides that "B" purchased the lease for $25,000—$10,000 cash and $15,000 purchase money mortgage. But "B", did not sign a promissory note in the amount of $15,000 in favor of "A" nor did he execute a mortgage granting to "A" a lien of $15,000 against the property. If the oil produced is insufficient to pay $15,000 to "A", then "A's" interest is terminated. "A" has no rights against "B" for the failure of the production payment to pay the full $15,000.

The factual situation in example "1" above is no different than the sale of real property by "A" to "B" with "A" reserving a life estate in the property.

Senator CURTIS. Mr. Chairman, could I ask a question?

Do you know anything about the origin of this in the House?

Is there something similar to this that does constitute an unwarranted tax shelter that they were trying to reach in this?

Mr. ROGERS. I do not know, Senator. All I know is——

Senator CURTIS. Let me put the question this way:

Is this sort of an arrangement that you described carried on for economic and business reasons or for purposes of a tax shelter?

Mr. ROGERS. In North Texas, primarily for economic reasons, because a man can pay more for his property where "A" sells to "B" and "B" says "I do not think your property is worth $25,000. I am not going to pay you $25,000, but I will pay you $10,000 and let you reserve out of the oil an oil payment in the amount of $15,000, if you think there is that much oil in the ground, but I am not willing to pay $25,000."

So that "A" then can actually realize $25,000 from the property; whereas, if he had to make a straight sale he could not realize that much out of the property.

Senator CURTIS. Suppose the provisions of the House bill were enacted, will it produce any additional revenue?

Mr. ROGERS. I think the Treasury had some testimony in the House. I would be unable to answer that question.

Senator CURTIS. Is this a Treasury proposal?

Mr. ROGERS. Yes, it was a Treasury proposal, but I might state, for background, that at no time in the House was there any testimony presented that this would be unconstitutional as taxing income from one person's property to some one else. That was never presented.

The CHAIRMAN. That is an interesting point. We have had lawsuits on about everything, but do you mean to tell me that we have never had a lawsuit go before the Court on the right of the Government to tax one man for the income of another man?

Mr. ROGERS. Senator, before you came in I cited the Supreme Court case. There is a case, a Supreme Court case, on that point which is in my testimony, and the Supreme Court held that it is unconstitutional and a denial of due process to tax one man on income from someone else's property. And the Treasury admits that that is the law, in a memo which they submitted to Congressman Bush. So, there is no question but what that is the law of the land.

Senator MILLER. Will the Senator yield?

As I understood, that was a case, however, involving an action by a State under the 14th amendment.

Mr. ROGERS. Yes.

Senator MILLER. And this is not an action by a State; this is an action by the Federal Government, so I am not too sure that the 14th amendment case would be applicable.

Mr. ROGERS. Senator, the Treasury Department, in the memo which I cite in my testimony here which they submitted to Congressman Bush, admits that this action would be a violation of the fifth amendment if it is a taxing of income from one man's property to someone else. In other words, the fifth amendment would apply, and I think the Supreme Court case in the *Hoeper* case clearly held that although the 14th amendment applies to the States, the fifth amendment would apply to the Federal Government.

(The memorandum referred to follows. Oral testimony continues on p. ——.)

MEMORANDUM RE CONSTITUTIONALITY OF THE TREASURY PROPOSAL REGARDING THE TREATMENT OF PRODUCTION PAYMENTS

PRESENT USAGE OF PRODUCTION PAYMENTS

Production Payment

The term "production payment" may be described as the right to a specified sum of money, bearing interest, payable out of a specified percentage of production from a mineral property or the proceeds received from the sale of such minerals, if, as and when produced. Depending on how a production payment is created, it may be classified as a carved-out production payment or a retained production payment. A production payment is secured only by an interest in the minerals, and therefore the known mineral reserves available are substantially in excess of that required to pay off the production payment. Thus a production payment is paid off over a period of time considerably shorter than the expected productive life of the property.

Carved-Out Production Payment

A carved-out production payment is created when an owner of a mineral property sells a production payment to an outside party, usually a bank or other financial institution. Under present law, the purchaser of the production payment treats the payments received as income and is entitled to cost depletion for the purchase price paid. The seller of a production payment immediately realizes ordinary income and is entitled to the allowance for percentage depletion. Thus if the owner of a mineral property "carves out" a production payment of $5 million (plus a sum equal to interest at the rate of 5½ percent per annum) payable from 75 percent of the minerals produced and sells it to a bank for $5 million, the owner immediately realizes $5 million of ordinary income, subject to depletion.

The use of carved-out production payments to convert future income into present income at whatever time and in whatever amount desired has led to significant tax reduction. When the minerals to satisfy the production payment are sold in subsequent years, the sale proceeds, to the extent of the production payment, are excluded from the gross income of the owner of the mineral property. But the production expenses are deducted by him in those years. This bunching of income in one year followed by tax deductions in subsequent years has permitted taxpayers to minimize the effects of those annual limitations on deductions and credits which are stated as a percentage of taxable income.

For example, assume that the owner of a domestic lead mine has fully recovered his capital investment and that the gross income from the mine in a particular year is $10,000,000. The percentage depletion rate for domestic lead is 23 percent, and his depletion deduction would therefore be $2,300,000. However, since the depletion deduction is limited to fifty percent of taxable income, if the production expenses of the lead producer were $9,000,000, his taxable income would be $1,000,000, and his depletion deduction $500,000. He would be required to pay tax on the remaining $500,000. By increasing taxable income through the sale of a production payment, the lead producers can increase his depletion deduction, because fifty percent of his taxable income will now be a larger figure.

In the following year a tax loss occurs because a substantial portion of the taxable income which the lead producer would have received in the second year has already been realized as a result of the sale of the production payment in the previous year. This tax loss can then be carried back to the first year, resulting in a refund of the tax paid in that year. Thus, the use of the carved-out production payment may have the result that no tax is paid over the two-year period although, but for its use, there would have been substantial taxable income for the two years.

ABC Transactions

A retained production payment is used in the so-called ABC transaction. A, the owner, sells a mineral property to B, who will own and operate it, taking a small down payment. A retains a production payment, which bears interest, for the major portion of the purchase price. A immediately sells the production payment to C (usually a bank or other financial institution) for cash.

A realizes capital gain (or loss), since his entire itnerest in the mineral property has been sold to B and C. C receives taxable income to the extent of the interest income from the production payment, since the principal amount of the production payment is recovered tax free through cost depletion. B excludes from gross income the mineral sales receipts used to pay off C's production payment. As a result of this exclusion, B recovers his capital investment in the mineral property much more rapidly in an ABC transaction than would be the case if he purchased the property outright, either with or without a mortgage. It is also generally possible for B to claim percentage depletion in the years after C's retained production payment has been paid off. Consequently, the total depletion deductions which can be claimed in an ABC transaction are greater than in cases in which a mineral property is purchased outright. For an explanation, see Wilknson, "ABC Transactions and Related Income Tax Plans," 40 Texas L. Rev. 18 (1961).

THE TREASURY PROPOSAL

In General

The Treasury proposal would treat a production payment as a loan by the owner of the production payment to the owner of the working mineral interest to which the payment relates. The owner of the working interest will include all receipts from the minerals produced in his gross income, subject to depletion. The owner of the production payment will not be treated as receiving income from mineral property, subject to cost depletion, but as a lender who receives a return of principal and interest. The result of these statutory changes will be to include in the same year the income and expenses of the owner of the working mineral interest. The purpose is to "stop artificial creation of net operating losses" in the mineral industry. Message of President Nixon to the Congress, dated April 21, 1969, Weelky Compilation of Presidential Documents, Vol. 5, p. 588.

Operation With Respect to Curved-Out Production Payments

Treating a carved-out production payment as a loan means that the cash received by the owner of the working interest at the time of sale of the production payment will be treated as a nontaxable receipt, just as borrowed money is treated. Therefore, except for interest and other expenses attributable to the sale of the production payment, the owner of the working interest will compute his income tax liability for the year the production payment is sold, and for the years it is being paid off, as the owner of the mineral property encumbered by a loan in the form of production payment.

The bank or other financial institution which owns a production payment would not be treated as an owner of the minerals in place who receives production payment income subject to cost depletion. Instead, it would receive the same treatment as any other lender whose loan is repaid with interest. Thus only the *interest* on the production payment would be included in the gross income of the owner of the production payment; the remainder of the payments received would be treated as a tax free return of the principal loaned.

Operation with respect to ABC transactions

Treating a retained production payment as a loan means that the owner of the working interest (B) will be required to include in his gross income the full amount of the proceeds from his sales of minerals to satisfy the retained production payment. He will be entitled to percentage depletion on all minerals produced and to deductions for the costs of producing minerals to satisfy the production payment, and for interest and other expenses incurred in connection with the satisfaction of the retained production payment. The net result of these changes will be to place the owner of the working interest in essentially the same position as other businessmen who purchase business assets subect to an outstanding mortgage.

The bank or other financial institution involved (C) will be treated in substantially the same way as a lending agency which owns a carved-out production payment. The seller of the mineral property (A) will continue to receive capital gain treatment.

CONSTITUTIONALITY OF THE TREASURY PROPOSAL

The Challenge

In a legal memorandum submitted to this Department for our consideration, the proposed treatment of production payments as loan transactions is assailed as a denial of the due process under the Fifth Amendment. The question presented is set forth in that memorandum as follows:

"Whether Congress would be violating the United States Constitution by enacting legislation which would require B in the following two examples to include in his income the income received by C from the production payment owned by C:

(1) B, a coal company, sells a $300,000 production payment to C. The production payment is payable out of 90 per cent of the net profits to be derived from the operation of the coal properties plus a sum equal to interest on said $300,000 at 5½ per cent per annum. The $300,000 will be liquidated in three years.

"The Treasury proposes to tax B on the $300,000 as received by C even though C receives the income from the production payment owned by C.

(2) A, the owner of a producing oil and gas lease, sells the lease to B for $1 million and retains a production payment of $3 million (plus a sum equal to interest at the rate of 5½% per annum) payable from 75 per cent of the production from the lease. Simultaneously, A sells the retained production payment to C for $3 million cash.

"The Treasury proposes to tax B on the $3 million as received by C even though C receives the income from the production payment owned by C."

The income of C under the Treasury proposal is stated to be $300,000 and $3 million in the two examples,[1] and it is said that Treasury proposes to tax this income of C to B. To avoid confusion as to the treatment of C, it should be pointed out that under the Treasury proposal the $300,000 and $3 million are not treated as C's income, but rather as a return of principal loaned. C's only income is the 5½ percent *interest* on the $300,000 and $3 million production payments. Without affecting the constitutional argument advanced in opposition to the Treasury proposal, the question presented can be framed in the setting of the proposed tax treatment of both B and C as follows:

Whether the guarantee of due process under the Fifth Amendment would be violated by legislation taxing B in the examples above on the proceeds of mineral sales used by B to pay off the production payments.

Three cases are cited in the text of the legal memorandum as support for the proposition that the Treasury proposal to tax B in the examples above on all

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[1] The first of the examples illustrates the use of a carved-out production payment; the second example illustrates the classic ABC transaction.

income from the production of minerals, including that used to pay off the $300,000 and $3 million production payments, is clearly unconstitutional.

The first of these cases, *Hooper v. Tax Commission*, 284 U.S. 206 (1931), held that an attempt by the State of Wisconsin to measure the tax on a husband by reference to the income of his wife denied him due process.[2] Assuming, for the sake of argument, the continued viability of this holding,[3] its relevance here is obscure. The Treasury does not propose to measure the tax on B's income by reference to the income of C; *it proposes to tax B's income to B*. This treatment could only be questioned if what Congress taxes as income to B is, in terms of the actual command and control over this income, in fact the income of C. This is a different constitutional issue from that present in *Hooper*, where the wife's salary, interest and dividends, etc., were admitted as a *fact* of that case to be her income, not her husband's.

The remaining two cases relied upon; *Poe* v. *Seaborn*, 282 U.S. 101 (1930) and its companion case, *Hopkins* v. *Bacon*, 282 U.S. 122 (1930), also fail to afford support for the constitutional attack on the Treasury proposal. It is said that in *Poe* v. *Seaborn* the Supreme Court held "that all of the income of the community could not be taxed to the husband because the husband did not own all of the community property." But this holding was based on a construction of the statutory phrase "net income of every individual" in the Revenue Act of 1926, not on constitutional doctrine. Indeed, the Court intimated that community income could constitutionally be taxed to one spouse when it referred to Congress' refusal to change the wording of the federal income tax to make community income "returnable as the husband's income." 282 U.S. at 116 and 114 fn. 6.

The response

The legal memorandum submitted to this Department offers no argument that the economic realities of transactions involving the use of production payments do not warrant treating such transactions as being in the nature of loans. Rather, the argument reduces to the contention that the owner of the working interest in mineral property may not be taxed on all income generated by the production of minerals when part of such income is used to pay off a production payment *owned* by a third party.

It may be conceded, as stated in the legal memorandum (p. 4, fn. 2), that "state law controls in determining the nature of the legal interest that a taxpayer has in property" and that the owner of a production payment under state law is the "owner of a vested property right."[4] The legal incidents of production payments under state law do not, however, preclude Congress from treating transactions involving their use as loans for federal tax purposes. It is well established that while state law determines the legal interests a taxpayer has in property, federal law determines how those legal interests are to be taxed by the United States. Therefore, the Treasury proposal cannot be regarded as unconstitutional solely because a production payment is an "interest in land" or a "vested right" under state law. The only possible constitutional issue is whether the proposed plan of taxing the working interest owner on all income from the production of minerals is so unreasonable that it violates the due process guarantee of the Fifth Amendment.

Argument

All mineral sales proceeds used to pay off a production payment are produced by the efforts of the owner of the working mineral interest, who extracts the minerals and bears all the expenses of production. Under present law, if he sells a production payment, he realizes ordinary income. In the absence of a production payment, the entire income derived from the sale of the minerals would be taxed to the owner of the working interest. In this situation, can it be doubted

[2] While *Hooper* involved due process under the Fourteenth Amendment as a limitation on state taxing power, no distinction between Fifth Amendment and Fourteenth Amendment due process is claimed here.

[3] Justce Holmes, with whom Justices Brandeis and Stone concurred, dissented on the grounds that husband and wife could constitutionally be consdered as an economic unit for tax purposes. Justice Holmes' view has since been vindicated. See *Fernandez* v. *Wiener*, 326 U.S. 340 (1945), in which the Court sustained a federal estate tax which treated husband and wife in community property states as an economic unit, thus—in principle—completely devitalizing *Hoeper*. Justice Douglas, in his concurring opinion in *Fernandez* v. *Wiener* (joined by Justice Black), endorsed Justice Holmes' criticism of the majority's view in *Hoeper*, 326 U.S. at 365–66.

[4] A mortgagee's rights might be similarly characterized, particularly in title theory states.

that Congress has the power to determine which event, i.e., the sale of the production payment or the sale of the underlying minerals, results in the realization of taxable income? Moreover, even if the sale of the production payment were considered the taxable event resulting in the realization of income, Congress could postpone the *recognition* of that income to the years of the pay out in a manner that would recognize the realities of the situation for tax purposes.

It is evident that the owner of the working interest has actual command and control over income from the production of minerals[5] and, apart from tax considerations, has equally enjoyed the fruits of his investment and labor whether he owns the property free and clear, or burdened by a production payment. Thus, regardless of the property interest the owner of a production payment is deemed to have under state law, it seems reasonable for Congress to require the owner of the working interest to include all mineral sales proceeds in his gross income, even if he must use a portion of those proceeds to pay off a production payment.

Indeed, it is because the present tax treatment of production payments is unreasonable, and results in the "artificial creation of net operating losses"[6] that remedial legislation has been proposed by the President. It may be worthy of note that while the proposed treatment of production payments was vigorously opposed by some witnesses at the Tax Reform Hearings,[7] its constitutionality was apparently not questioned.

The courts have considered the nature of production payments. In *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 (1958), the Court examined the question whether the consideration received for an assignment by the taxpayer, the owner of the working mineral interest, of a carved-out oil production payment was taxable as ordinary income, subject to depletion, or as capital gain. While conceding the premise that oil payments were "interests in land" under Texas law, the Court held that the consideration received for such payments was taxable as ordinary income, subject to depletion. *Id.* at 264. Speaking for a unanimous Court, Justice Douglas stated (356 U.S. at 266–67): "These [production payment] arrangements seem to us transparent devices. Their forms do not control. Their essence is determined not by subtleties of draftsmanship but by their total effect." After discussing precedents involving the assignment of income doctrine, the Court concluded that it was clear that the taxpayer was simply "converting future income into present income." The Treasury proposal would simply prevent this from being done for tax purposes through the use of production payments.

In *Anderson* v. *Helvering*, 310 U.S. 404 (1940), the Court held that the owner of the working interest in mineral property was taxable on the proceeds of mineral production used to pay off a "production payment."[8] This "production payment" was secured by an interest in the oil and gas production *and* by an interest in the fee title to the lands conveyed. This additional security, in the opinion of the Court, served to distinguish a contrary result reached in *Thomas* v. *Perkins*, 301 U.S. 655 (1937), where a production payment was only payable out of oil if, as and when produced.

This difference in the security interest involved in the *Thomas* v. *Perkins* and *Anderson* v. *Helvering* cases is, of course, not a difference of constitutional dimensions.[9] The essence of a lending transaction is not affected by the nature of the security interest involved.[10] It follows that there can be no constitutional objection to the Treasury proposal which would merely extend the rule of

[5] In fact, for tax purposes, he can use a carved-out production payment to increase his taxable income for a particular year to an amount he desires.

[6] The present tax treatment of production payments also results in special tax preferences unavailable to taxpayers financing nonmineral property. Efforts to obtain the tax advantages of production payments in the purchase of nonmineral property have not been successful. See *Bryant* v. *Commissioner*, 399 F.2d 800 (5th Cir. 1968) (purchase of farm); *Larry D. Hibler*, 46 T.C. 663 (1966), aff'd per curiam, 383 F.2d 989 (5th Cir. 1967), cert. denied, 390 U.S. 949 (1968) (purchase of insurance agency).

[7] See, for example, Hearings before the House Committee on Ways and Means on Tax Reform, 1969, 91st Cong., Part 9, 3162–64 (1969). The Treasury proposal was also supported. *Id.* at 3427–29. And the neutral suggestion was made that the same results could be reached by employing such techniques as income deferral or reserves for estimated expenses. *Id.* at 3357–58.

[8] Of course it is not tenable to argue that the Supreme Court reached a result contrary to the Constitution.

[9] As the Court stated in the *Anderson* case, "The holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place." 310 U.S. at 410.

[10] We understand that it is accepted banking practice to treat production payments held by banks as loans.

Anderson v. *Helvering* to all production payment transactions, regardless of the nature of the underlying security.[11]

In an analogous situation the Congress exercised its power to base tax consequences on economic realities without regard to state law characterization of property interests. In 1956 a court held that a person retaining a Maryland ground rent was the actual owner of the property under Maryland law, and therefore a builder who sold houses subject to such rents did not have to include the capitalized value of these rents in determining his gain from the sale of houses. *Commissioner* v. *Simmers' Estate*, 231 F.2d 909 (4th Cir. 1956) ; followed in *Welsh Homes, Inc.* v. *Commissioner*, 279 F.2d 391 (4th Cir. 1960). To avoid getting whipsawed, the Treasury ruled that payments of ground rent were no longer deductible as interest.

Said the House Committee on Ways and Means in its Report on a bill to reverse these decisions by legislation:[12]

Your committee believes, without regard to the formal legal theory involved, that the result obtained under the court decision in practice is the wrong result. It sees no reason why the home buyers in Maryland should receive smaller deductions for tax purposes with respect to payments made on their homes than is true of taxpayers elsewhere with respect to similar payments made on their homes.

On the other hand, there also appears to be no justification in permitting the seller of the property in these cases to reduce the gain at the time of his sale below that which would be realized in other States merely by making use of the redeemable ground rent device available in Maryland, rather than a purchase money mortgage which generally would be used in most other States to achieve substantially the same results.

Legislation enacted provided that "any annual or periodic rental under a redeemable ground rent * * * shall be treated as interest on an indebtedness secured by a mortgage." Section 163(c) of the Internal Revenue Code. Section 1055 was added to the Code, subsection (a)(1) providing that "a redeemable ground rent shall be treated as being in the nature of a mortgage." Similarly, the Congress has constitutional power to provide that production payments shall be treated as loans. In fact, one court reached this result on the rationale that an assignment of a production payment was "similar in effect to a mortgage upon real estate." *Commissioner* v. *Slagter*, 238 F. 2d 901, 904 (7th Cir. 1956).

Conclusion

The legal argument submitted to the effect that the Treasury proposal would be unconstitutional misconceives, we believe, the concepts underlying the Treasury proposal. It is not proposed to tax the income of C to B. Rather, it is contemplated that the economic realities of production payment transactions will be recognized for tax purposes. Thus B will be taxed not on C's income, but on income which B derives from the sale of minerals he has extracted, even though B has entered into a contract obligating him to pay a portion of the mineral sales proceeds to C. It is inconceivable that the proposed treatment of production payments denies B due process of law as guaranteed by the Fifth Amendment.

Since a bill to carry out the Administration proposal has not yet been introduced in the Congress, necessarily the above discussion has been based entirely upon the basic concepts contemplated by the proposal. The Congress will certainly be careful to insure that these concepts are implemented in a constitutional manner. In light of the above discussion, there is no question that this can be done.

The CHAIRMAN. It was a constitutional amendment that gave a right to tax a person's income. But that is his income it gives the right to tax.

Mr. ROGERS. That is right.

The CHAIRMAN. Not the right to tax him for somebody else's income. That is what you are saying.

[11] Such legislation, by treating the consideration for assignment of a production payment as a loan to the owner of the working interest, would moot *P. G. Lake*.

[12] H. Rept. 24, 88th Cong., 3 (1963). To the same effect, see S. Rept. 72, 88th Cong. 2–3 (1963).

Mr. ROGERS. That is correct.

The CHAIRMAN. Of course, that is obvious, on the face of it, I would think.

Mr. ROGERS. Yes; it is.

The CHAIRMAN. But I can't predict what they will do over there. I hope they will become more predictable as time goes by.

Mr. ROGERS. I am just about finished here.

The factual situation is no different than the sale of real property from "A" to "B" with "A" retaining a life in the property. This happens every day in America. During "A's" lifetime the income from the property is taxable to "A", not to "B". This is true because "A" owns the life estate (a vested property right) and has the legal right to receive the income from the property. Any attempt by Congress to tax such income to "B" would be unconstitutional. (*Hoeper* v. *Tax Commission of Wisconsin, supra.*)

You could not tax, the Congress could not pass a law to tax, "B," the remainder man on "A's" income, because "A" is the life tenant and he receives all the income as long as he lives. Also, the factual situation in example "2" above is no different than the sale of any property interest for a term certain. For example, if "B" owned an apartment house and sold it to "A" for a 3-year term certain, the income from the apartment is taxable to "A" during such 3-year period, not to "B," does not have the right to the income.

The Treasury Department in its memo delivered to Congressman Bush has attempted to defend the proposed statute on the ground that taxpayer "B," the owner of the mineral property, should be taxed on the proceeds from the sale of all of the oil, "since 'B' has extracted the oil from the ground even though 'B' has entered into a contract obligating himself to pay a portion of the oil sales proceeds to 'A'." The fatal error made by the Treasury in making that quoted statement is their total lack of knowledge of who owns and sells the oil in the ground. In our first example; "A" owns 50 percent of the oil in the ground until he has received $15,000. "A" sells his oil in the ground to the purchasing oil company and receives payment direct from that purchaser. "B" does not receive any part of the proceeds from oil sold by "A" or by the royalty owner. "B" has no contract to pay over any part of the oil sales to anyone. Moreover, if the reasoning of the Treasury is sound, then "B," the mineral property owner, would be required to include in his taxable income all of the proceeds from oil sales including the amounts paid direct by the purchasing oil company to the other owners of property interests; that is, royalty owner, overriding royalty owner or the net profits owner. Such a position is absolutely absurd.

It follows then that a congressional attempt to tax income from a mineral production payment to a person who does not own the production payment represents a denial of due process of law. The mere fact that Congress designates certain transactions as a loan will not result in creating taxable income when, in fact, the income from the property is not the taxpayer's income.

These proposed statutes remind me of a story attributed to Mr. Lincoln. It is told that in the course of cross-examination he asked: "How many legs does a dog have?" The adverse witness replied: "Four." Mr. Lincoln then said: "If you call the tail a leg, how many legs does the dog have?" To which the witness replield: "Five." Mr. Lincoln then said: "No, sir, you are wrong, calling the tail a leg don't make it a leg."

Senator CURTIS. I want to make sure I understand your example. "A" sells a producing mineral property to "B" for $10,000, reserving unto himself a $15,000 production payment. Now, how much does "B" agree to pay "A"?

Mr. ROGERS. $10,000. He pays him $10,000 cash for the property.

Senator CURTIS. And does "B" give him any kind of a mortgage?

Mr. ROGERS. No notes, no mortgage; nothing. In the actual conveyance, the statement is than made that "A" reserves the right to a $15,000 production payment out of oil sales if and when made, and if there are no oil sales made, then "A" is not going to get anything more besides his $10,000. If, let us say, $5,000 is recovered by "A", then that is all "A" gets, and he has no right to sue "B" for the $10,000 or the $15,000, or the balance.

Senator CURTIS. Thank you.

Senator BENNETT. I was not here in the early part of your testimony. Is "A" required only to deliver to "B" half of the income he receives from the oil in the ground?

Mr. ROGERS. Let me state it this way: After the sale is made then oil is produced. Fifty percent of the oil—well, first, all of the oil is sold to, let us say, Mobil Oil Co. Now, let's say in 1 month there was $5,000 in oil sold off that one well. Mobil would pay $2,500 to "A" and $2,500 to "B" direct.

Senator BENNETT. That is the point I wanted to get clear.

Mr. ROGERS. Until "A" recovered out of his 50 percent, $15,000.

Senator BENNETT. Then, Mobil is given notice of the ownership of the oil?

Mr. ROGERS. Yes.

Senator BENNETT. And it is required to make its payments in accordance with that agreement.

Mr. ROGERS. That is correct, Senator.

Senator McCARTHY. Thank you very much.

Senator HANSEN. Mr. Chairman, if I could, in order that I understand this more clearly than I do now—would I infer from your example that "B" in purchasing this mineral property for $10,000 is not necessarily assured that there will be a recovery of $15,000 worth of oil?

Let me state it differently. If "A" receives $15,000 additional in production payments, it would not necessarily follow—I mean if "A" receives $15,000 additional money in production payments, it would not necessarily follow that "B" would get the same amount because he has got to pay the cost of producing this oil; is that correct?

Mr. ROGERS. That is correct. "A" is paid out of the gross, and "B" of course is going to have to pay for the lifting costs, because he is going to operate the property. That is right.

Senator HANSEN. Thank you, Mr. Chairman.

Mr. ROGERS. Thank you very much.

(The following letter was subsequently received for the record with respect to the testimony of the preceding witness:)

AMERICAN BAR ASSOCIATION,
Washington, D.C., October 7, 1969.

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

DEAR SENATOR LONG: On Wednesday, October 1, 1969, the Senate Finance Committee received a statement from Harold D. Rogers of Wichita Falls, Texas, dealing with the taxation of production payments as proposed by section 501(b) of the bill. In his statement Mr. Rogers says that the position being urged has been approved by Mr. Leland Fiske, Chairman of the Natural Resources Committee, Taxation Section, American Bar Association (Testimony of October 1, 1969, p. 345).

The purpose of this letter is to advise the Committee that the approval of Mr. Fiske is his individual view. The Section of Taxation has not taken a position with respect to section 501(b). As pointed out in my statement to the Committee on October 3, 1969, the Section of Taxation has not been authorized to support or oppose proposals of a controversial nature affecting the distribution of a substantial part of the tax burden to a particular class or classes of taxpayers. In my judgment, comments by the Section of Taxation on Section 501(b) would be barred by this limitation.

Respectfully yours,

SCOTT P. CRAMPTON.

Senator MCCARTHY. Prof. Arthur W. Wright.

STATEMENT OF ARTHUR W. WRIGHT, PROFESSOR, DEPARTMENT OF ECONOMICS, UNIVERSITY OF MASSACHUSETTS

Mr. WRIGHT. Mr. Chairman, members of the committee, my name is Arthur Wright. I am assistant professor of economics at the University of Massachusetts, in Amherst, Mass. Thank you for permitting me to appear before you here today, to testify on the important matter of the tax treatment of natural resource industries. I shall confine my remarks today to a brief summary of the written statement submitted to the committee.

I have also submitted a background paper and a document containing some comments on the Mid-Continent Oil & Gas Association's critique of the Treasury CONSAD report, which report I shall touch upon briefly today.

With the chairman's permission, I would like to have these materials placed in the written record of these hearings following my written statement.

After considerable study, I have concluded that there are three undesirable aspects of our present tax treatment of the natural resources industries. First, this tax treatment is an important source of unfairness in the Federal tax system. The present tax rule for natural resources makes it possible for many extremely wealthy individuals to pay less Federal taxes than persons living in what the Federal Government defines as poverty. The present tax rules also enable corporations engaged in mineral production to pay far less Federal taxes than do other corporations.

Second, the present tax treatment of natural resources is a wasteful and inefficient form of subsidy, the need for which has not been demonstrated. I would suggest that the proponents of continued mineral tax subsidies should have more faith in the ability of the American free-market economy to produce minerals and fuels without Federal aid.

Third, the present system of mineral tax subsidies creates severe administrative burdens for Government and business alike. The areas of greatest administrtaive difficulty concern so-called economic interest questions, depletion rate determinations, cutoff point questions, unit price computations, and the 50-percent net income limitations on percentage depletion deductions.

Regarding the second aspect which I mentioned, there is a distinct lack of hard evidence that we need tax subsidies for natural resources, or that the present system of subsidies is even very efficient. The Treasury's CONSAD report, published in March 1969 jointly by the House Ways and Means Committee and this committee, and the only thorough study to date of the effects of the present system, found these tax subsidies to be inefficient. The CONSAD report has withstood the many criticisms leveled at it by the petroleum industry, most notably by the Mid-Continent Oil & Gas Association.

I urge the industry to commission studies of equivalent stature and thoroughness to the CONSAD report rather than merely criticizing this report.

A number of claims in support of continuing the present system of tax treatment for natural resources industries have been put forward. I find most of these claims to be without substance.

For example, claims that natural resource producers now pay their fair share of taxes typically use misleading bases for comparison, such as gross income instead of taxable income, or else they inconsistently lump together foreign taxes, Federal taxes, local taxes, and user charges when computing the so-called industry tax burden.

It is also claimed that the present tax treatment of natural resources is needed to let natural resource producers recover their capital investment in mineral properties. In fact, true recovery of capital can be accomplished through cost depletion. Present tax treatment, which allows percentage depletion, is defective because it permits tax-free recovery of amounts far greater than the mineral producer's original capital investment. Such tax treatment discriminates against other industries that must also attract substantial amounts of capital investment.

It is also claimed that percentage depletion helps keep gasoline prices down. The Treasury has recently estimated there would be an increase in the price of gasoline at retail of less than one-half cent per gallon if the percentage depletion rate were reduced to 20 percent. If we really want low retail gasoline prices, we can reduce them not by less than one-half cent per gallon but by several cents per gallon by removing the import restrictions and the Federal support for market prorationing.

Finally, the mineral industry spokesmen claim that their tax benefits should be continued because industry rates of return on capital are low. First of all, there are strong doubts that they are, in fact, lower than those of nonmineral industries. Rather, the data suggests a rough equality. This is what we would expect in the American market economy, rates of return tending to equalize in all industries after taking into account the tax benefits granted each industry.

In summary, I find the present program of tax assistance to the natural resource industries an inequitable, wasteful, problem-ridden Government aid program. I urge the committee to introduce legislation to scrap the existing aid program and substitute depletion computed on the basis of actual cost, together with capitalization of intangible drilling costs and their recovery over the useful life of the property, as is done for business investment in other industries.

The natural resource provisions in the House bill, H.R. 13270, which is here under review, in my opinion constitute a step in the right direction. However, I find it regrettable that both the House bill and the administration's proposals in response to that bill failed to eliminate percentage depletion entirely and most particularly failed to require full capitalization of intangible drilling and development costs.

Thank you.

Senator McCarthy. Does that complete your statement?

Mr. Wright. Yes.

Senator McCarthy. Do you have any questions?

Senator Hansen. Thank you, Mr. Chairman.

I would like to ask unanimous consent to insert in the record the analysis and comment relating to the CONSAD report on the influence of U.S. petroleum taxation on the level of reserves as compiled by the Mid-Continent Oil and Gas Association.

Our distinguished witness has referred to that report, and I think it might be helpful to the committee if they had the opportunity to review it in the context of his remarks, the observations and the analysis made by Mid-Continent.

(The report referred to follows. Testimony continues on p. 4647.)

Analysis and Comment Relating to the CONSAD Report on the Influence of U.S. Petroleum Taxation on the Level of Reserves

Summary

The conclusions of the CONSAD report can be given no credence because:

I. The mathematical formula (an "economic model") from which the conclusions are drawn is conceptually inappropriate for the purpose.

II. CONSAD, itself, issues repeated warnings about the pitfalls of its model-building. The combined impact of these cautions is a clear signal that CONSAD should have rejected this model, as it did two other models—and as it did *this* one for natural gas.

III. The quality of the data used in the formula is questionable, as is the method of manipulation.

IV. There are factual errors in the report.

V. The study proceeds from a number of doubtful premises about the economics of the petroleum industry.

I. Inappropriateness of the CONSAD Formula

The CONSAD study employed mathematical methods to predict the change in petroleum reserves that would result from elimination of percentage depletion. A fundamental error was made by using a formula that cannot answer this question. It was assumed that *production would not change* in the event of an increase in petroleum taxation, and the formula was designed to determine the level of reserves that would be required to accommodate the assumed fixed level of production.

Once it made the assumption that outut is fixed regardless of profitability, it was inevitable that CONSAD would find that there would be little change in the desired level of reserves, since the required level of reserves is technologically determined by the level of production. It is indisputable, owing to the nature of petroleum deposits, that any given level of production requires a supporting amount of reserves which is a multiple of production—as CONSAD acknowledges on page 7.3 of the report. (To produce one barrel of oil annually, there must be about ten barrels of supporting reserves in the ground.)

CONSAD actually ignored the *real* problem, which is how the long-run level of output would change in reaction to a decrease in profitability resulting from increased taxation. Instead, CONSAD indefensibly assumed that the desired level of production is independent of the level of profitability of the industry.

Indeed, the CONSAD model makes no provision for unprofitability (except at a zero price of crude oil). The mathematical model is so formulated that it tells us that the industry would find and develop reserves even if price were less than cost. Any model which states that businessmen desire to invest when price is less than cost is indefensible because no firm desires to invest at a loss.

II. CONSAD Cautions

CONSAD raised such an extended and serious list of objections to its own procedures that the reader should be convinced of the mathematical formula's lack of merit without further independent inquiry.

The formula was developed for use in describing the behavior of individual firms in manufacturing. CONSAD questioned whether the formula would be reliable if extended to the petroleum industry—see page 6.31.

CONSAD also questioned whether the historical data employed can be used to predict the future—see pages 6.12 and 6.13. In the report, it was said that "If the quantity of reserves necessary to support a certain level of output has changed during the period of the study, it will cause errors" in the estimates—page 6.13. (In fact, the ratio of proved reserves to production actually *has* declined steadily since 1960.)

CONSAD warns that reliable economic models require reliable data. In addition to the problem of finding reliable figures, it was recognized that there are massive problems in using the data. Perhaps the best example is finding costs, "the most ambiguous area in the data in this study"—page 6.16. Computing industry finding costs involves multiple difficulties, e.g., (a) the impossibility of determining from industry data when the exploration dollars for a given year's discoveries were actually spent; (b) the difficulty of estimating how much has been found until a number of years after discovery; and (c) the random variability of the amount spent per barrel found from year to year.

III. Statistical Problems

The CONSAD report points out that there are "many missing links" in the quantitative data available for making a reliable economic study—page B.1. It nevertheless proceeded with the study on the basis of estimated data and often relied on doubtful stand-in data to estimate the effects of important items for which it could not obtain direct information. Moreover, the data were used to predict the effect of a change in industry taxation for which there is no historical precedent. Such an extrapolation beyond the range of historical experience violates fundamental statistical principals.

IV. Incorrect Information

The report contains factually incorrect statements. Some involve data—even matters as basic as the current level of U.S. crude oil production. Others refer to petroleum tax provisions which do not exist.

If a research company is so unfamiliar with the petroleum industry as to err on basic data and tax provisions, it is unlikely to have sufficient knowledge of the industry to be able to develop accurate complex mathematical models for analyzing industry behavior.

V. Doubtful Petroleum Economics

Some of the premises of the CONSAD study are, in our opinion, based on unreliable assumptions about the economics of the industry. A notable example of these propositions asserts that Canadian crude reserves can "substitute" for United States reserves. However, the amount of crude oil imports from Canada is limited by agreement between the two governments. Since crude oil imports from Canada are controlled, Canadian reserves—like overseas reserves—are not substitutes for U.S. reserves. Thus, CONSAD should not have suggested Canadian and U.S. reserves in its economic model. And drawing conclusions from this model entailed the error of assuming that changes in the U.S. tax law would have the same effect on Canadian reserves as on domestic reserves.

Conclusion

No useful conclusions can be drawn from the CONSAD study because the mathematical model and the data are defective and because some of the basic premises are not appropriate. Indeed, it was predestined that CONSAD's exercise would be futile because CONSAD assumed that production would not change in the event of an increase in petroleum taxation.

Furthermore, we firmly believe that *no* aggregative mathematical model of the oil industry—no matter how sophisticated—can be used as a guide to estimating the effects of eliminating percentage depletion. Two of the most important reasons for this are:

(1) Part of the period upon which such a model must be based (the 1950's and 1960's) was one of industry readjustment to excess capacity, a readjustment now well on the way to completion.

Sound statistical theory holds that projection of a past period assumes that any changes that occurred in the base period will be repeated in the future. Since further significant adjustment to excess capacity is not likely, the 1950's and 1960's cannot be used as a base period for forecasting the future.

(2) The largest year-to-year crude oil price change since 1950 was +30¢ per barrel (1956 to 1957). Elimination of percentage depletion would be equivalent to a price reduction of about 75¢ per barrel. Thus, any prediction of the results of such a tax change based on a model reflecting the 1950's and 1960's would require extrapolation far beyond the limits of the base period data.

Sound statistical theory holds that such extrapolation is invalid because there is simply no historical basis for evaluation how firms would react to changes so far beyond the range of experience.

CONSAD admitted the existence of these problems, but it proceeded undeterred.

Our criticism is not so much that CONSAD's exercise predictably proved futile, as that CONSAD drew serious public policy conclusions from its mathematical model despite the obvious and admitted statistical problems involved in constructing any such model. The model used is especially subject to criticism because it is based on the improper assumption that industry exploration and development expenditures are not dependent on an adequate rate of return.

INTRODUCTION AND CONCLUSIONS

This paper is a review of the recently released CONSAD Research Corporation Report on *The Economic Factors Affecting the Level of Domestic Petroleum Reserves*. This report has been widely quoted as concluding that elimination of percentage depletion would cause the firms in the industry to reduce the total desired level of proved crude oil reserves by only 3%, while elimination of percentage depletion and the right to deduct intangible drilling costs in the year of drilling would, together, reduce the desired level of reserves by only 7%.

The CONSAD conclusions are based on an economic model which is inappropriate for evaluating the effect of a tax increase on desired reserve holdings. This model was estimated and applied using old and doubtful data and generally questionable techniques. Furthermore, the study contains a number of statements which can be shown to be factually incorrect, as well as a number of questionable statements on the economics of the petroleum industry. In fact, the study is not even internally consistent in several places. Given these various problems, documented in detail below, the CONSAD conclusions can be given no credence.

CONSAD set out to evaluate three models:

(1) A so-called "neoclassical" model purporting to relate the desired level of reserves in the long run to production, price, and cost;

(2) An industry "behavioral simulation" attempting to relate exploration and development expenditures to some general measure of industry performance such as rate of return; and

(3) An individual firm simulation model attempting to determine mathematically how an integrated or non-integrated producer might react to changes in petroleum taxation.

The second model "could not be developed" (3.5) [1] because of CONSAD's inability to find a "significant relationship between the rate-of-return measures and expenditures for exploration and development". (6.51) "Consequently the development of a model of this type was determined to be infeasible at this time." (6.52)

The third model was developed, and we are told at the beginning of the report that the results are "mutually supportive" (3.5) of the results of the first

[1] Figures in parentheses in this report are page numbers in the CONSAD report, which uses chapter-by-chapter pagination.

model. Later in the report, however, CONSAD admits the "lack of quantitative significance of the firm model" which is "due in part to the lack of data on which to base it." (6.53) "The outputs of this model cannot serve as quantitative estimates of the effects of tax policy changes on total reserve levels . . ." (6.52) If this model cannot provide quantitative estimates, it is clear that CONSAD has no basis for alleging that it supports the results of the first model.

In short, the whole CONSAD result depends on the theoretical and statistical viability of the (first) model which attempts to relate the desired level of reserves to price, cost, and output. This report's purpose is to appraise this model. We shall, in turn, discuss:

(1) The theoretical invalidity and general non-applicability of the so-called neoclassical model, and CONSAD's failure to consider the relevant policy questions;

(2) The warnings which CONSAD itself issues about the difficulties of formulating such a model for the petroleum industry;

(3) Problems in CONSAD's statistical analysis;

(4) Apparent factual errors in the CONSAD report; and

(5) Certain doubtful propositions which CONSAD develops about the economics of the industry.

The general conclusion of our appraisal is that the CONSAD analysis is conceptually unsatisfactory and statistically unsound. Thus, as is made abundantly clear in numerous statements in the report itself, it simply cannot provide reliable prediction of the likely reaction of petroleum firms to a substantial and unprecedented change in the basic economics of the industry. Consequently, it cannot serve as even a "base point" in the formulation or reformulation of public policy in this vitally important area.

I. THE "NEOCLASSICAL" MODEL

The source of CONSAD's conclusions, the Reserve-Reaction Forecasting or Neoclassical model, is based on arguments that were developed by Professor Dale W. Jorgenson of the University of California (Berkeley). Jorgenson's research, as reported in a series of recent papers, centered upon his attempt to apply what he has called a "neoclassical" approach to the problem of forecasting *short-term* changes in the level of investment spending. In the CONSAD report, one part of Jorgenson's model is used for the rather different problem of predicting the volume of petroleum reserves that petroleum producers will want to hold in the *long run* under different conditions.

This chapter first examines the model and its applicability to petroleum production. In the second part, emphasis is placed on those aspects of the model that are especially inappropriate in the CONSAD application. The final part covers published academic criticism of those of Jorgenson's assumptions which are both common and critical to the CONSAD analysis.

A. *CONSAD's question*

The question which CONSAD seeks to answer is this: If petroleum taxes were raised, how much reserves would the industry desire to hold at various levels of output, *assuming that those levels of output would be produced*. Specifically, in drawing its conclusions, CONSAD asked how much reserves the industry would have liked to hold in order to produce a particular level of output (the level produced in 1966): (1) with present taxation and (2) with increased taxation.

This question is almost trivial, and CONSAD itself provides an adequate answer on the very page on which it presents its basic model:

"There is a definite technological relationship (represented by the MER[2]) between the stocks held and the level of production. This limits the amount that can be produced from a given level of stocks, and requires a producer to maintain certain levels of stock to meet certain levels of production. Due to the MER, no more than a certain percentage of the total reserves can be produced during a year." (7.3)

Thus, the level of reserves required for a given output is technologically determined. *Assuming that the output will be produced come what may*, the answer to CONSAD's question is a function of the technology of the industry. As will be shown below (p. 32), U.S. crude reserves in 1968 were ten times production.

[2] MER is the maximum efficient rate at which a field can be produced.

Allowing for some excess capacity, this is the answer to CONSAD's question.

It is not surprising that CONSAD found little responsiveness of desired levels of reserve to price changes, since it assumed that the 1966 level of output *would* be produced—profitable or not. With output fixed, the level of reserves *should* remain unchanged. Thus, CONSAD's question is basically trivial and is not the question that is relevant for public policy.

The question of real public policy significance is one having two parts. First, what quantity of output would firms want to produce at various prices? And second, what level of reserves is implied by those levels of output? Put this way, the question allows for the possibility of a zero answer if production becomes unprofitable. Put CONSAD's way, a level of output (and by implication, effort to add to reserve) is assumed *regardless of profitability;* and the elaborate CONSAD procedure merely attempts to determine the amount of reserves compatible with the output—something already technologically determined.

B. The Basic Model

In its simplest terms, the CONSAD argument is that the amount of "desired reserves" which petroleum producers will want to hold in long-run equilibrium is equal to the expected level of production multiplied by the ratio of the price of output to the cost of reserves.

$$\text{Desired Reserves} = \text{Production} \times \frac{\text{Price of Output}}{\text{Cost of Reserves}} \times \text{Technological Constant}^{3}$$

The problem with this formulation can be seen by asking what happens to desired reserves if price falls so much relative to cost that the industry becomes unprofitable. If expected production remains constant, as CONSAD *assumes*, the formula indicates that desired reserves would decline and that firms in the industry would want to abandon (draw down without replacement) some, *but not all*, of their reserves. This is clearly an unrealistic result; for as long as investment is unprofitable, firms will not want to hold *any* reserves in the long run. But this theoretically inappropriate formula tells us that firms in the industry would want to develop and hold some amount of reserves at any price greater than zero—even if that price were less than cost. Only if price is *zero* can this multiplicative formula give a zero reserve answer. But any rational description of long-run economic behavior must indicate zero net investment *whenever investment is unprofitable*, not simply when price is zero. (Price less than cost is no mere academic issue here, since the price which CONSAD uses to arrive at its final conclusion *is* below cost, based on its cost data.)

Probably the main reason why the CONSAD model gives this irrational answer is that it is *incomplete*. It considers only one of the many relationships that would determine the long-run equilibrium of an industry; and, in particular, it does not explain the level of production of the industry. However, it is the level of production of the industry which determines the desired level of reserves. If the industry becomes unprofitable, firms would cease to produce and therefore would cease to invest in new reserves. The CONSAD model is unable to account for this possibility.

The formulation actually used in the CONSAD analysis is somewhat more complex than the basic relationship discussed above, but it is still subject to the same fundamental criticism. The CONSAD model requires a number of highly restrictive and unrealistic assumptions some of which are discussed below.

C. Specific Objections to the CONSAD Model

Specific objections to the CONSAD model as it is applied to the petroleum industry relate to the formulation of the model and to the various assumptions. The assumptions which are most objectionable include (1) the "Production Function" on which the model is based; (2) the assumption of perfect extensibility beyond the range of available observations; (3) the assumption of perfect knowledge; and (4) the assumption that aggregation problems are minimal.

(1) The "Production Function" on Which the Model Is Based

The basic CONSAD model rests on the assumption that competitive firms will want to add to their holdings of capital (in this case, reserves) as long as the value of the output attributable to an additional unit of capital is greater than the cost of acquiring the unit. According to economic theory, the same relationship must hold for all factors of production (land, labor, capital, etc.), so that in

[3] See the equation on page 7.3. The technological constant is omitted in the text, we believe inadvertently. It appears earlier and later.

long-run competitive equilibrium, the value of output attributable to the last unit of each factor will be equal to the cost of its acquisition.

With this as a basis, the CONSAD "neoclassical" approach assumes that we can determine the amount of capital that an industry will want to hold simply by determining how the value of the output attributable to additional units of capital varies with the amount held. This, in turn, is determined by manipulating what economists generally refer to as a "production function," a device which describes the technologically feasible alternative combinations of factor inputs which will result in various levels of output.

In an analysis such as CONSAD's, the specification of the production function is a matter of critical importance. In fact, the choice of a production function really determines the results that will be "found." For this reason, it is notable that the choice of a production function in the CONSAD analysis is essentially arbitrary with absolutely no basis in industry characteristics or technology. Thus, we are told:

"The exact relationship to be expected depends on the form of the production function which applies to the industry, and on this there is comparatively little evidence. Due to lack of strong evidence to the contrary, a first-degree constant elasticity of substitution production function was assumed . . ." (7.7)

With no evidence supposedly available, a particular function was simply "*assumed.*" Actually, however, the production function which is used for most of the computations involves a further—but no less arbitarary—assumption:

"It should be noted that although the assumption of a CES (constant elasticity of substitution) production function is common in the literature, and is reasonable on its face, the explicit assumption of constant returns (to scale) is not supported (nor made suspect) by any empirical evidence. Consequently it seemed appropriate to calibrate a CES function of degree greater than one . . ."(7.7)

Again, with no empirical evidence, it "*seemed appropriate.*" In our opinion, there *is* convincing evidence on the nature of the production function for oil and gas; and an understanding of the inappropriateness of CONSAD's arbitrarily assumed production function is vital in evaluating CONSAD's work.

CONSAD's production function assumes that labor can be substituted for capital (in this case oil reserves) to produce a particular level of output. To us, this is not a realistic description of the oil industry. With a given state of technology, the ultimate recoverable output of a field cannot be increased by applying more labor to it. With MER production, the only way to get more output of oil is to find more oil pools. Labor is not a substitute for oil in producing oil. As CONSAD itself tell us, the required amount of reserves for a given annual output is fixed by MER, which is technologically determined (see the quote from (7.3) on page 4 above).

Thus, the appropriate production function for petroleum is one allowing no substitution between labor and capital. The proper formulation of the equation explaining desired reserves should be:

Desired Reserves=Production × Technological Constant

Since labor cannot be substituted for capital, CONSAD's assumption that production will remain constant *requires* that reserves remain constant. This formulation indicates clearly the triviality of CONSAD's question.

Another questionable property of CONSAD's production function is the assumption of increasing returns to scale—i.e., as more labor *and* capital are used to increase the scale of operations, progressively larger increments in output result. The implication is that the minerals industry uses the best deposits *last*. On the contrary, to the extent to which the quality of deposits is known (and the very significant problem of uncertainty is ignored in the CONSAD analysis), the minerals industry would logically use the best deposits first; that is, the production function would show decreasing returns to scale.

(2) *The Assumption of Perfect Extensibility*

Another fundamental problem with the CONSAD analysis is the assumption that relationships observed over a particular range of historical data necessarily will hold outside that range at some point in the future. This is the assumption that allows CONSAD to predict the effect of eliminating the percentage depletion allowance (equivalent to 75 to 80¢ per barrel before taxes) on the basis of the observed reactions to changes in price that were no larger than 30¢ during the sample period.

In discussing this point CONSAD observes that—

"Since some of the possible tax policy changes evaluated are of greater magnitude than any past changes, it may well be that the adjustment of the industry to changes of this magnitude may not be completed for a period of years." (3.2)

In truth, when projecting beyond the range for which there is information and when using the projected results for public policy recommendations, the speed of adjustment—while important—is probably the *least* important concern. In fact, the dangers of extrapolation are so basic, one is led to wonder why "speed of adjustment" is stressed, while the truly significant problems are not discussed.

As soon as we attempt to go beyond the range of the available data, the *statistical* validity of any results declines precipitously. Beyond the range of observed variation, there is absolutely no way to guarantee that the observed relationships will continue to hold. In fact, if one is to predict the petroleum industry's response to a change in (effective) price that is 2½ times greater than any observed in the past, he must first refute a presumption that the actual response would be totally different. In this case, predictions from a statistical model alone are not sufficient. Clearly, little information is available to support the validity of the fitted equation or even its general form, once one ventures outside the range of sample data. These problems cannot be dismissed merely with a reference to possible delays in adjustment. Given the limited range of observations and given the presumption that the industry response would be quantitatively and qualitatively quite different, the more logical reaction would have been to dismiss the results.

(3) *Perfect Knowledge*

The assumption of perfect knowledge or complete certainty is fairly common in econometric analyses. The reason is generally one of convenience rather than "common sense or casual observation." For a small manufacturing firm renting capital *services* in a perfectly competitive capital market, the assumption may be tolerable, especially when compared to the other assumptions that are required for econometric studies. However, such an assumption is totally inappropriate where investment means searching for petroleum.

Over the years, the fundamental uncertainty of petroleum exploration has been amply documented in the public record. Additional evidence can be drawn from the record of lease bid ranges (as originally proposed by Professor James W. McKie in 1960). Lease bids in particular auctions reflect different companies' valuations of the same properties. Since, in the typical sale, each company is free to explore and study the property in question, complete certainty would suggest that the variation in bids would be small. However, as illustrated by the results in the table below, taken from public records, it is not uncommon for the winning bid in a particular sale to be many times the low bid and even double or triple the second highest. These wide variations in bids from companies with similar access to pre-bid information make it clear that the actual circumstances of oil and gas exploration are anything but perfectly certain as assumed in the CONSAD report.

LEASE BID RANGES, SELECTED AUCTIONS

	Companies	Bid per acre	Percentage of winning bid
Navaho Sale No. 90, Window Rock, Ariz. (1968)	Pan Am	$250.13	100
	Gulf	123.72	49
	Corine Grace	31.84	13
	Humble	31.10	12
	Kerr McGee	26.66	11
	Depco	17.03	7
	George Hunker	12.19	5
	Champlin	10.10	4
	Union of California	7.25	3
Corpus Christi Bay, Nueces County (1968)	King Resources	100.10	100
	J. B. Clark	61.42	61
	Tenneco	53.11	53
	Atlantic	40.31	40
Lafourche Parish (1966)	Texaco	216.68	100
	Union of California	117.00	54
	Union Products Co	60.49	28

(4) *The Assumption That Aggregation Problems Are Minimal*

Another fundamental problem is the assumption that the activities of thousands of petroleum producers can be lumped together, explained, and predicted in a simple three-variable model based on industry aggregate data.

One aspect of the problem is that the basic "neoclassical" or "desired capital" model is really applicable only for an individual firm. The importance of this particular problem is difficult to judge; but it may be worth noting that after a series of attempts to apply his version of the neoclassical model to aggregate investment expenditures, Jorgenson's most recent work deals with individual firms.

Another aspect of the aggregation problem noted by CONSAD is that "in dealing with average figures for a number of firms, *little information is usually available about the distribution.*" (6.5)

In truth, however, there is enough information in the case of the petroleum industry to make questionable any conclusions that are drawn from an analysis of aggregate industry data. Evidence on the distribution of most of the factors which CONSAD lumps together is readily available from public sources, e.g., U.S. and Canadian reserves. Moveover, a convincing demonstration of the significance of CONSAD's problem is provided by the econometric work of Professor Edward Erickson. Erickson's study (cited by the Treasury but not by CONSAD) shows that petroleum prices and the volume of exploration activity are closely related but only when the econometrician gives proper recognition to regional differences in exploration conditions and differences in the size or type of firms undertaking the exploration. Failure to take account of regional and firm differences in reserves, prices, access to capital, etc., would have restricted the usefulness of the CONSAD analysis even if the model had been somehow appropriate.

D. Academic Criticism of the "Neoclassical" Model

Before examining CONSAD's own reservations about its work, it will be of interest to inquire into what other economists have said about the "neoclassical" approach.

Jorgenson's "neoclassical" approach to investment forecasting has been the subject of considerable critical comment in the professional economic literature. Since the CONSAD formulation is too recent to have received comment and since many of the principal assumptions are the same in both, it is important to take note of the published views of some prominent economists on Jorgenson's studies.

First, on the lack of realism and the general restrictiveness of Jorgenson's assumptions, Professor Roger F. Miller of the University of Wisconsin has observed:

"I strongly doubt that the prominent neoclassicists, were they alive and well read today, would find much interest in a model which assumes away uncertainty with regard to future lags in adjustment, difficulties in aggregation and composition, discontinuities, etc."[4]

A more detailed listing of Jorgenson's assumptions, is provided by Professor James Tobin of Yale University. Citation of Tobin's list is appropriate not only because the assumptions are unrealistic but also because the complete list is never presented in the basic CONSAD document:

"In Jorgenson's world of perfect competition and perfect knowledge . . .

"(Jorgenson's firm) purchases capital *services* at a market rental, just as it purchases labor at a market wage. There is a perfect market in capital goods: capital is homogeneous in quality regardless of its vintage, and capital evaporates exponentially, so that future depreciation is also independent of vintage. Thus, any surviving capital can always be sold at the prevailing price of new capital."[5]

Additional questions relate to the assumption of equilibrium and to the restrictions which this places on the types of problems that can be addressed. This point was best expressed by Professor Zvi Griliches of the University of Chicago:

"In the Jorgenson model, one cannot answer the question of what happens to the rate of investment if the rate of interest or other prices *shift* to a new per-

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[4] Roger F. Miller, "Comment on Jorgenson" in Robert Ferber, ed., *Determinants of Investment Behavior*, New York: NBER, c. 1967, p. 164.

[5] James Tobin, "Comment on Crockett-Friend and Jorgenson," in Robert Ferber, ed., *op. cit.*, p. 156.

manent level in one move of if a change occurs in depreciation rules. A discontinuous jump to a new accumulation path is not admissible".[6]

Note, however, that it is just such a shift in tax policy which is the problem addressed by CONSAD.

Professor Griliches has asked further:

"Are the desired capital change variables significant because they are largely equal to the change in sales or output, or does the specific 'neoclassical' deflation of these changes by the elaborate 'user' cost of capital concept really do the trick?"[7]

Professor Griliches never answers these questions, but the recent publications of Professor Eisner of Northwestern University provide some indications:

"In most critical instances, it will be found that empirical tests contradict Jorgenson's assumptions and with them the deductively derived conclusions."[8]

These criticisms of the "Neoclassical" model of investment behavior are in the literature. Surely CONSAD should have taken them into consideration and stated its reasons for believing that these criticisms do not vitiate the appropriateness of the CONSAD model.

II. CONSAD CAUTIONS

CONSAD goes to great length to point out the multiple problems associated with attemping to set up any mathematical model describing the response of petroleum exploration to changes in economic factors, affecting the industry. Our only basic quarrel with these cautionary passages in the report is that the authors do not take them to heart. Rather, they elected to move ahead undeterred and use the mathematical derivation described in the prior chapter as a basis for drawing major public policy conclusions about an industry whose continued growth is vital to the military and economic security of the nation.

CONSAD expresses three general reservations about mathematical evaluation of the responsiveness of petroleum exploration to increased taxation:

(1) Whether investment analysis developed for manufacturing firms can validly be applied to petroleum;

(2) Whether appropriate quantitative estimates of a Jorgenson-type "neoclassical" model are feasible, based on historical data; and

(3) Whether the data used for the four principal variables in the total industry formula (reserves, price, cost, and production) were reliable and appropriate.

A. *Applicability to Petroleum of Investment Analysis Developed for Manufacturing Firms*

CONSAD warns that—

"Investment analysis, as developed for manufacturing is best applied with caution to the oil industry." (6.3)

CONSAD lists three reasons for this caution: (1) the industry is assumed to be "neither growing very rapidly nor declining"; (2) the theory applies to "a single firm"; and (3) "the oil industry does not invest in quite the same way as other industries do." (6.3 and 6.5)

(1) *Static industry*

CONSAD states:

"The oil industry, and particularly its exploration sector, has so far as it is possible to tell from the sparse financial data available, been passing from a period of high and increasing demand and high profits to a period of more stable demand and lower profits." (6.3)

Where there has been a change in a fundamental factor during the base period for an historical economic model, use of that model to forecast the future implicitly assumes that the change will continue as it did in the base period. Hence, the model will give invalid results if the change has, in fact, been a transition which is complete. We agree with CONSAD that

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[6] Zvi Griliches, "Comment on Crockett-Friend and Jorgenson," in Robert Ferber, *op. cit.*, p. 161.

[7] Zvi Griliches, "The Brookings Model Volume: A Review Article," *The Review of Economics and Statistics*, Vol. 1 (May 1968), p. 216.

[8] Robert Eisner and M. I. Nadiri, "Investment Behavior and Neo-Classical Theory," *The Review of Economics and Statistics*, Vol. 1 (August 1968), p. 370.

"The immediate past may well have been a period of readjustment for the industry . . .; and extrapolation from this period may thus not be entirely relevant to the future of the industry." (6.4–6.5)

We shall address this point in more detail later.

(2) *Individual Firm Decisions*

CONSAD then states:

"The behavior of an entire industry is more difficult to explain than that of a single firm, particularly since . . . Industry aggregate data may obscure some of the underlying behavior of the individual firms." (6.5 and 6.7)

This reservation about the validity of attempting to estimate the reaction to a petroleum tax increase by observing past industry aggregates rather than by examining the economics of individual firm investment decisions was what led CONSAD to attempt to develop the individual firm simulation model mentioned in the Introduction to this report—a model which "lacked quantitative significance" once it was completed.

(3) *Capital Investment Process*

CONSAD argues that the process of capital formation in oil differs from manufacturing in that a good part of the investment base is immediately deductible for tax purposes (the losses are literally sunk capital):

"This may be taken to indicate that capital has been relatively more free to move in and out of exploration and can, therefore, be sensitive to expected prqfit; or it may suggest that, since it is easier to "pull out," there is less need to be sensitive to small fluctuations in expected profits as measured by realized profits in the previous period." (6.6)

We read this to say that petroleum explorers will probably not react quickly to small changes in profits, but that they can—and will—react significantly if a profit change persists. This reaction will either be to pull out or to increase expenditures, as the case may be. The lag between profit change and reaction will be long; but the reaction will occur if the profit change proves to be other than transitory. The length of the lag will also be difficult to predict because industry reactions are the sum of individual reactions; and various firms will undoubtedly react differently to a given change.

How could a research organization which can so accurately appraise the process of petroleum capital formation in *qualitative* terms permit itself to fall into the trap of believing *quantitative* results which are, on their face, patently unreasonable?

B. Quantitative Reliability of Models Based on Historical Data

CONSAD also lists three reasons for caution on this point: (1) rational businessmen base decisions on "expectations of future values" which may not be accurately represented by historical observations; (2) historical observations "may represent transient, rather than equilibrium, conditions; and (3) historical observations may be distorted by technological change during the base period." (6.12–6.13). The second of these is the same as the first caution in (A) above.

(1) *Expectations*

CONSAD states:

"First, and perhaps most important, rational operators are basing decisions not on past values of variables but on their expectations of future values." (6.12) Of course, past experience is relevant in estimating future expectations. However, "in trying to develop quantitative results, one must explicitly consider just how these expectations might be formed." (6.12) ". . . Obtaining data on current expectations is fraught with problems, and obtaining historical data on expectations was essentially impossible." (7.12)

CONSAD recognizes that one must consider how expectations might be formed and that it was impossible to obtain any historical data on expectations. Yet CONSAD proceeded with estimating the "neoclassical" model. How? By using "some variable for which data was available and which might reasonably be assumed to reflect the expectations which existed at the time . . ." (7.12) The result was that producers' expectations were represented by: first-order exponentially weighted moving averages of costs (7.20); second-order exponential moving averages of production (7.25); and actual prices.

The matter of explorers' expectations is of critical importance in any model which seeks to predict the effect of eliminating the percentage depletion allowance. The allowance is worth about 75 to 80¢ per barrel before taxes; and the largest year-to-year price change since 1950 was +30¢ (that change was largely eroded within two years). Thus, "one of the objectives of the study was to predict the effects of changes which exceeded the range of the calibration data." (7.8)

How explorers will react to a 75¢ equivalent price decrease is impossible to predict from their reactions to very small price changes. The effect on their expectations for the future of the industry could be catastrophic, especially since the change would come via repeal of a tax provision which originated a half century ago during the formative years of the corporate income tax.

(2) *Transient Conditions in the Base Period*

CONSAD observes that there will be problems in utilizing the base period data if they reflect transient conditions rather than equilibrium. We have seen that this is crucially important in evaluating the reliability of a mathematical model of reactions to increased petroleum taxes.

In the first place, as CONSAD recognizes, the industry was reacting to excess capacity during the base years:

"There is clear evidence that excess capacity existed during the entire period studied . . ." (7.10)

Surely a base period when firms in the industry were reacting to substantial excess capacity is of dubious value for forecasting industry reactions in long-run equilibrium.

Next, CONSAD is impressed by industry structural changes as firms reacted to excess capacity, particularly after the first Suez crisis of 1956–1957: "The industry structure and pattern of expenditures changed in 1957 or thereabouts, with one pattern being exhibited prior to this time, and a second totally different pattern . . . exhibited after 1957." (6.25)

This change "will make it hazardous to use the past behavior of the total industry (over the last twenty years) to judge possible behavior of the industry in the future." (6.24–6.25)

Rather, "it is the more recent years which should be most closely modeled because of the apparent period of adjustment during the 1950's and because the later years are the only period indicating any sensitivity of expenditures to rate of return " (6.46)

Having recognized the "hazards" and the need for restricting the model to "later years," CONSAD proceeded to base its "neoclassical" model on the period 1951–1965. Not only does this model carry the figures back into a period CONSAD itself rejects, it cuts off 1966 and 1967.

(3) *Technological Change*

CONSAD states:

"The final major problem in this approach, . . . is the question of the stability of technology during the period studied. If, in fact, the quantity of reserves technologically necessary to support a certain level of output has changed during the period of the study, it will cause errors in the quantitative relationships estimated." (6.13)

There can be no question that the ratio of reserves to production has, in fact, changed. Chart A shows that the ratio may have trended up slightly until 1960 and then began a persistent decline.

Early in the report, CONSAD itself quotes a 1968 Department of the Interior statement that the ratio had dropped to 10.4:1 (2.7). However, this point is ignored in estimating the model, where the use of 12:1 is qualified only by the following remark:

"While there is evidence that such a change occurred, there exists some evidence as to the direction and magnitude of that change, thus making it possible to at least estimate its effect on the relationships." (6.13)

CONSAD clearly knew of the technological change, witness its own reference to the Department of the Interior study:

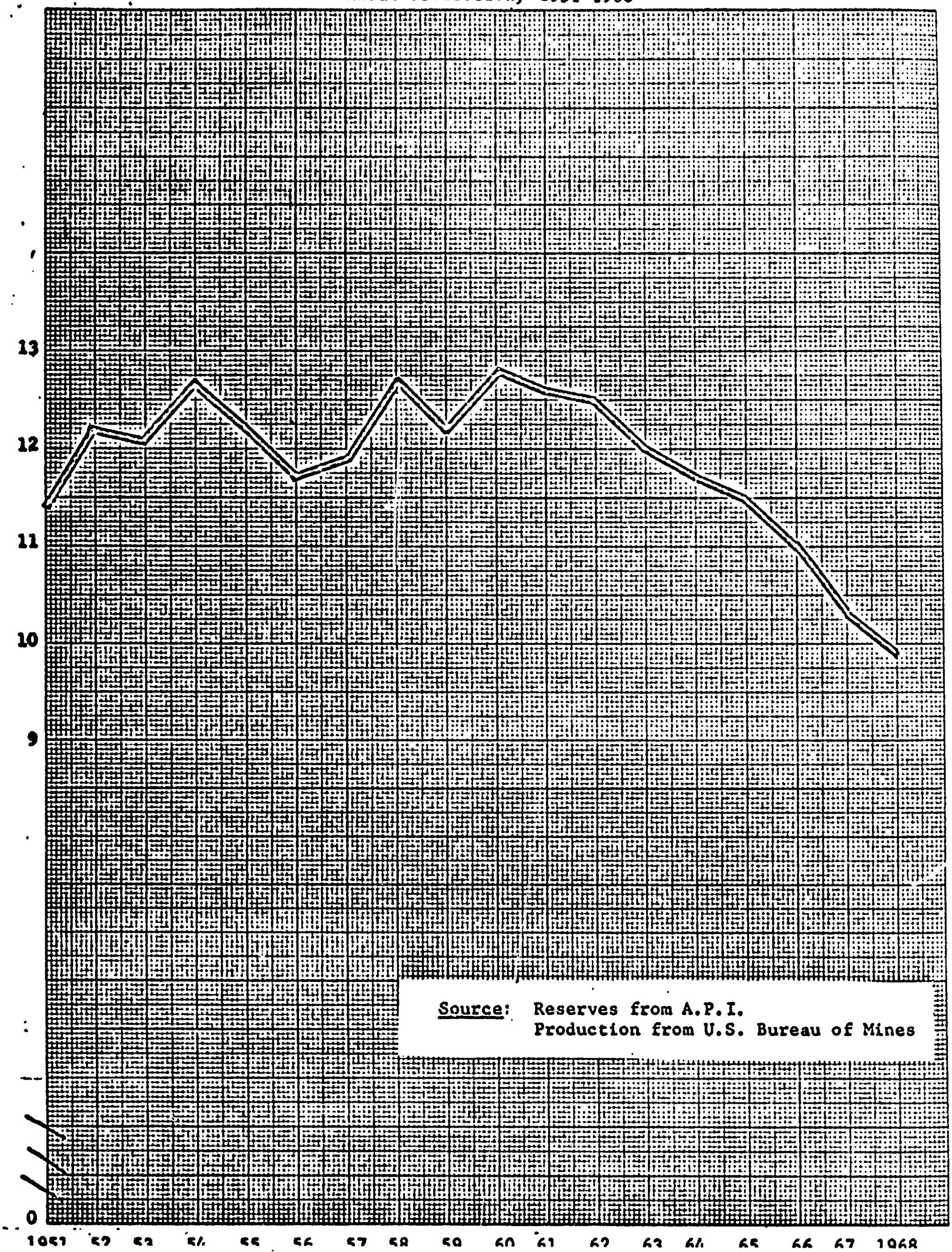
"This large increase in well productivity . . . implies that the reserves needed to support a given level of production on a technological basis have declined by 36% since the period 1944 to 1948. The economic significance of this point is stated in a Department of the Interior report:" (2.7)

Then, quoting Interior:

"In view of this fact, it no longer appears necessary to maintain a ratio of proved reserves to production in the vicinity of 12 to 1 to insure the producibility of reserves at required rates." (2.7)

In short, even though it called the reader's attention to the fact that errors "will" be caused by a reduction in the ratio, CONSAD apparently made no modification of its results to reflect the technological change.

Chart A
Ratio of Proved Reserves of Crude Oil to
Annual Production, 1951-1968



There are other examples of technological change which occurred during the base period and which cannot be expected to continue at the same pace, e.g., a rapid increase in the use of fluid injection for secondary recovery and fracturing of certain formations to increase recoverable reserves.

C. Reliability of Petroleum Data

CONSAD warns us of serious limitations in the data used to calibrate the model. We use two of these as examples:

(1) Finding Costs

"Finding" costs as used in the study are actually finding *and* development costs. According to CONSAD:

"The definition of finding cost is perhaps the most ambiguous area in the data in this study." (6.16)

There are three reasons for this (6.17):

(a) How to measure what is found;

(b) "Relatively poor data available on actual costs of exploration and development activity"; and

(c) "Discovery is . . . a random event."

The problem is this: First, one does not know how much he has found with any degree of certainty for many years after the discovery. This is a particularly serious problem when the measure of discoveries is proved reserves, since reserves only appear in these data when they are actually put in the working inventory. The time lag can be quite long. Furthermore, it is impossible to determine from aggregate industry data when the exploration dollars for a given year's discoveries were actually spent. And the amount spent per barrel found will vary considerably from year to year on a purely random basis as discoveries vary.

CONSAD finally relied on total expenditures for exploration and development divided by gross annual additions to proved reserves of oil and gas (gas converted to liquid equavalent on something like a value basis). This measure is also sometimes used in the industry. However, the measure is used *only* as a rough measure of capital requirements, not as a precise input to a mathematical model—and certainly not as a precise measure of the cost of new discoveries. Very little of the money spent in a given year is associated with the oil actually found in that year, and gross additions are *not* "discoveries," as mis-labeled by CONSAD (A.37). Gross additions are composed of extensions, revisions, and conservative first-year estimates of new discoveries. The proportions of these components change over time (see Chart B), and the new discovery component is quite small.

(2) Price

CONSAD states:

"Because of the unique nature of petroleum and natural gas reserves, the appropriate measure of price is particularly difficult to determine." (7.14)

Why?

"A price decline would be expected to lead in the long run to *lower* reserve stocks.[9] (7.15)

"In the short run, however, it might result in a cutback in production which would *increase* reserve stocks above planned levels, since the planned depletion of reserves would not occur."[9] (7.15)

In other words, observing the historical relationship between price and reserves can lead to an exactly opposite conclusion from that appropriate to a long-run model, since history is composed of a series of short-runs.

(3) Summary on Data

There were also problems with all other data used to calibrate the model. (At various points in the report, three different methods were used to estimate lifting costs—see 6.34; 8.3; and 9.13.) Using finding costs and price as examples, finding costs were "ambiguous"; and an appropriate price was "particularly difficult to determine." Yet CONSAD was not deterred from applying the "neoclassical" model to oil—even though data problems caused it to reject the other two models. And CONSAD even rejected a "neoclassical" model for natural gas because of data problems.

[9] Italics added.

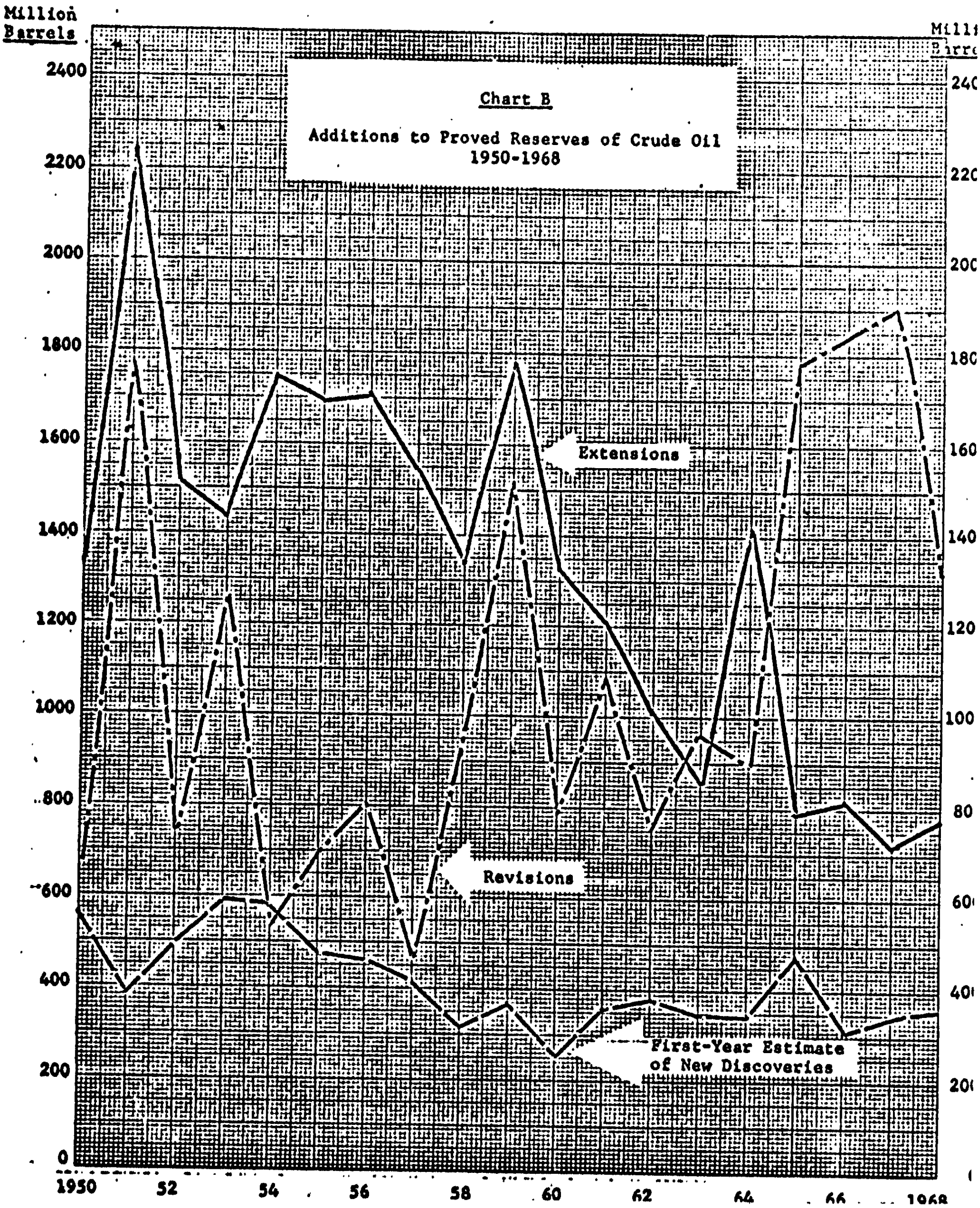


Chart B
Additions to Proved Reserves of Crude Oil
1950-1968
Million Barrels
2400
2200
2000
1800
1600
1400
1200
1000
800
600
400
200
0
Extensions
Revisions
First-Year Estimate of New Discoveries
1950
52
54
56
58
60
62
64
66
1968

III. STATISTICAL PROBLEMS

This chapter deals with statistical aspects of the CONSAD report. Attention is directed to the quality of the statistical analysis including the appropriateness of the data inputs and the success of the statistical manipulations.

A. Data

As with most parts of the analysis, a critical discussion of the data inputs can best begin with CONSAD's own qualifications and cautions. Thus, in a section on problems of data collection, CONSAD states that:

"Throughout this study there have been substantial difficulties in obtaining data which would have broadened the analysis undertaken. *There are so many missing links in the quantitative evidence available that it is difficult to know which to rank first.*" (B. 1)

To overcome these "missing links" CONSAD has tailored its analysis to fit the data which are available, even when this does violence to the underlying logic:

"The purpose of this study required that the investment hypotheses chosen meet two criteria—first, that data be available to calibrate it, and, second, that it include as determining variables the magnitude which would change with changes in tax provisions." (6.3)

Both criteri are necessary, but neither should be allowed to take precedence over logic where the analysis is to form the basis for public policy.

More specific examples of this tailoring include the following:

"The approach taken here is somewhat different for two reasons. One is that the data for most of the variables of interest is available only on an annual basis. The other is that the primary objective of the study is an estimation of the long run effects of certain policy changes, and in view of the paucity of the data available, it seems advisable not to attempt the estimation of an excessive number of parameters." (7.4–7.5)

And, "the choice of a single-equation model over a multiple-equation model was based on the paucity of data available for model calibration . . ." (7.9)

A second technique employed to compensate for "missing links in the quantitative evidence" is the use of "proxy" variables—variables which stand in for the quantities actually desired. For example well head price plus the after-tax value of percentage depletion was used as a proxy for price minus income tax. Objections could be raised to each of CONSAD's proxy variables. An obvious and not atypical example, however, is the interest rate which forms one element in the important "user" cost formulation. Without explanation, CONSAD uses what purports to be the Aaa corporate bond rate (4.5% *before* taxes for 1966—actual average was 5.13%, now 7.5%). Apparently the rationale for this is that the Aaa rate is used by Robert M. Coen, the source of CONSAD's "user" cost formulation. But if this is the case, it is important to take note of the comments presented by Coen:

"Choosing an appropriate measure of "the interest rate" raises many problems regarding the definition and measure of the cost of funds to firms. (Miller and Modigliani) have found that for the electric utility industry the AAA bond yield is far superior to a weighted average yield on bonds and equities in predicting both the level of, and magnitude of changes in, the cost of funds. Whether or not this is also true in the manufacturing sector is unknown, since research in this important area is just beginning." [10]

If we are to be expected to accept the Aaa corporate bond rate as a reasonable reflection of what petroleum producers expect for their cost of capital, something more convincing is needed than a reference to Modigliana and Miller's admittedly distinguished work with electric utilities, particularly when one considers that only six companies in the oil industry have the Aaa rating. Of course, no one borrows for exploration (unless the loan is secured by other income or assets). Hence, the cost of capital for exploration must be the long-run return to equity in the United States (say, 10% *after* taxes) plus a substantial risk premium to compensate for exploration uncertainties. CONSAD, itself, uses 9% after taxes elsewhere in the report (4.30).

B. Problems of Estimation

It is characteristic of the model which CONSAD attempts to estimate, that once the particular form is specified, the regression analysis is not terribly

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[10] Robert M. Coen, "Effects of Tax Policy on Investment in Manufacturing," *American Economic Review*, May, 1968, p. 204.

important. The reason, quite simply, is that the values of the coefficients are so constrained that whatever values are indicated in the regression analysis are of marginal significance. With this as background, one could probably ignore the regression analysis on the ground that it is unimportant, were it not for the fact that the analysis itself contains some fundamental and important errors.

The principal problem in the multiple regression analysis is the problem of interrelated independent variables, or as it is called by the econometricians, "multicollinearity." This problem is described by CONSAD as follows:

"For the model here, the question is whether any of the independent variables in the capital stock equation are in fact dependent on the other variables in the system. It might be proposed, for example, that the observed production values are functions of price, or that the current cost of new capital stock is a function of the existing quantity of capital stock. If this is true, then the single-equation model will produced biased estimates of the parameters." (7.10)

CONSAD devotes considerable effort to arguing that the independent variables in their regression, price/cost and production, are not highly correlated. At no point, however, do they provide the only suitable evidence, *the set of correlation coefficients.*

Our computation and analysis of these coefficients using the basic CONSAD data shows that the two independent variables, the price/cost ratio and lagged production, *are* highly correlated. In a situation such as this, the statistical validity of any multiple regression results accordingly must be highly suspect.

Just how suspect CONSAD's results may be can be seen if we attempt to duplicate their results using U.S. data instead of aggregated U.S. and Canadian data. Using CONSAD's data sources and model, a series of regressions was computed to relate U.S. proved reserves to the price/cost ratio and to U.S. production. As in the CONSAD analysis, the two independent variables were highly correlated, but the effect of the multicollinearity in this case was to leave the coefficient for the production variable in the multiple regression analysis statistically insignificant. This kind of result is only to be expected where multicollinearity is a problem.

C. Problems of Application

The principal problem with CONSAD's application of the model is the problem of extensibility. As explained above it is simply not legitimate to use historical data to predict how firms might react to a fundamental and unprecedented change in the basic economics of the industry—especially when the base period is atypical and when serious public policy matters are at issue.

Other problems of application suggest the pervasiveness of the theoretical and statistical problems. In this regard, it must be considered curious that in estimating and applying the model, lifting costs are never mentioned except where they are used to calculate income taxes.[11] If this version of the neoclassical model permits us to disregard labor and other costs even though these *must* affect the profitability of the industry, this point should be noted and explained. Jorgenson's original formulation had a separate equation for labor inputs—not used by CONSAD.

Equally curious is CONSAD's use of a formula to measure the cost of reserves that was designed to measure the cost of the annual services of a machine. Since this approach leads CONSAD to compare the price of a *full* barrel of reserves with the cost of only a *fraction* of a barrel, some explanation is required as to how the formula is applicable. Unfortunately, none is offered.

D. General Appraisal

Given the problems with the data inputs and given the problem of multicollinearity, the general appraisal can be brief. The essential point is that made by Professor Eisner when confronted with similar evidence in earlier Jorgenson models:

"All in all, there appears to be scant *empirical* support for the usefulness of the neo-classical model of capital accumulation."[12]

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[11] "Lifting costs" are current well operating expenses, e.g., labor maintenance, power, etc.
[12] Eisner, *op. cit.*, p. 375.

IV. APPARENTLY INCORRECT INFORMATION

In our opinion, the following statements are factually incorrect:

CONSAD Statement	*Facts*
1. The United States is a net importer of foreign oil . . . the quantity is restricted to 12.2% of domestic demand . . . (4.4)	1968 Domestic Demand, 13,016 million barrels per day. 1968 Total Imports, 2,857 million barrels per day. Total Imports divided by Domestic Demand, 21.9%
2. Import restrictions . . . effectively limit crude imports to 12.2% of domestic crude production. (6.15)	1968 Domestic Crude Production, 8,648 million barrels per day. 1968 Crude Imports, 1,273 million barrels per day. Crude Imports divided by Domestic timated 387 billion barrels for 1965.
3. The IOCC estimate . . . is the only available estimate of oil originally in place in known fields . . . 346.2 billion barrels [1962] . . . (4.18)	The Department of the Interior has estimated 387 billion barrels for 1965.
4. The current output of crude oil is approximately 7 million barrels a day. (4.22)	1968 production: 8.65 million barrels per day.
5. The ratio of reserves to production has remained consistently in the region of 12:1. (4.23) The ratio of proved reserves to production has remained virtually constant at 1:12 (sic) for 20 years. (5.12)	1-1-1968 Reserves, 31.4 billion barrels. 1968 Crude Production, 3.17 billion barrels. Reserves divided by Production, 9.9. (See Chart A, page 4638)
6. Crude oil and natural gas are bound together . . . (4.24)	76% of U.S. gas reserves are in non-associated reservoirs (part of the remaining 24% is from non-dissolved gas caps over oil deposits).
7. Depletion is calculated for each property separately, or in certain cases, on specified aggregations. (4.38) . . . the small producer . . . has not the benefit of property aggregation to spread his deductions and avoid the net income limitation. . . . (8.9)	Since 1963, aggregation has been prohibited (except within an individual lease), regardless of the size of the producer.
8. Alternatively, a recent provision (1956) permits capitalized and accumulated intangible costs to be deferred and expended over the five years following the discovery of the well. This may allow the net income limitation to be avoided altogether. (4.40)	We know of no such provision.
9. foreign . . . depletion . . . amounted to a total of $655,000,000 in 1960. . . . This represents 23% of all depletion claimed. (5.19)	Most of this "claimed" depletion was not effective because foreign tax credits prevented payment of U.S. tax on foreign production.
10. . . . there are no direct import restrictions on natural gas. (6.16)	Federal Power Commission approval is required for all such imports.
11. Since assets result from past expenditures, an initial estimate of the assets committed to crude oil production activity was obtained by summing three years' expenditures for exploration and development (the past two years' and the present year's). . . . using [this base] . . . a rate of return was computed. (6.34)	Present cash flow comes from sale of reserves developed over a period of many years, not just the last three. Thus, the rates of return on Chart 6.5 are far too high.

CONSAD Statement—Continued	*Facts*—Continued
12. Some firms operating abroad pay up to approximately 70% in royalties. The standard domestic royalty is ⅛ although many are higher. (8.9)	In general, royalties in foreign producing countries are approximately the same as in the United States.
13. The integrated major producers . . . [may have] economic power . . . great enough to enable them to force independent producers to bear the burden of the increased taxes, by reducing field prices and thus increasing the profitability of refining operations.	Even if it had the economic power (which no producer does), an integrated company would hardly do this. Why? The action would reduce only the cost of that fraction of its crude which is purchased. However, a crude price cut would reduce the cost of *all* crude refined by it nonintegrated competitors, thereby leaving the integrated company at a competitive disadvantage in refining.

If a research company is so unfamiliar with the petroleum industry as to err on basic data and tax provisions, can it possibly have sufficient knowledge of the industry to be able to develop accurate mathematical models for analyzing industry behavior?

V. DOUBTFUL PETROLEUM ECONOMICS

The CONSAD report takes a number of positions on key petroleum economics issues which we believe to be wholly inadequate. These positions lead us to wonder whether the authors have relied on the intensive direct appraisal which should be a prerequisite to suggestions of public policy changes in any industry.

Ten examples of what are, in our view, serious misconceptions about the economics of the industry are:

(1) The substitutability which CONSAD assumes to exist between United States and Canadian reserves.

(2) The allegedly adverse resource allocation effects of petroleum taxation.

(3) The supposed insensitivity of exploratory activity to rate of return. CONSAD concluded on the basis of a defective measure of rate of return (see page 34 above) that there is no relationship between rate of return and exploration, except a weak relationship for larger companies during the period 1957–1965, (6.51).

(4) The adequacy of A.P.I. proved reserves data for use in evaluating exploratory results (see page 24 above).

(5) The picture of an industry operating as a monolith or as two groups (large and small companies) rather than as a large number of individual firms making individual decisions in reaction to price and cost.

(6) The picture of an industry "satisfied" with a modest return reflecting lackadasical operation rather than an industry pursuing vigorous technological improvement programs designed to improve profits. A realistic picture of the actual situation is provided in the National Petroleum Council Volume, *Impact of New Technology on the U.S. Petroleum Industry 1946–1965.*

(7) The industry's supposed ability to "*double*" the recoverability of oil in place (4.18). The Department of the Interior predicts only a one-fourth increase between 1965 and 1980, and that is very likely optimistic.

(8) The concept of wildcat "success" used in the report, CONSAD correctly states that "discovery value on a successful well is many times higher than actual outlays made for that particular well" (4.37) but then takes the position that one wildcat in ten is "successful"—whereas the number is more like one in fifty.

(9) The attempt to apply overseas development patterns to United States reservoirs in order to determine how many excess wells have been drilled here.

(10) The conflicting statements on the alleged economic power of large producers who are said to control a "large share of production" (2.5) and are then said to operate in an industry "which is not highly concentrated" and where the top five producers account for only "20% of the output."

In order to illustrate the problems involved with these CONSAD positions, we shall discuss our objections to the first two in some detail.

A. Substitutability of U.S. and Canadian Reserves

In estimating its "neoclassical" model, CONSAD combined United States and Canadian reserves. CONSAD's stated rationale for this surprising treatment of the data is:

"Examination of the United States-only reserve/production ratio indicates that it has been gradually declining, while the Canada-only ratio has been rising." (6.14)

From this, CONSAD reasons:

"For both of these to be due to rational decisions on the part of firms, either the expectation must be that Canadian production will be rising much more rapidly than United States production, or the firms involved consider the United States and Canada as a single market." (6.14)

CONSAD concludes that the "latter seems intuitively more plausible." (6.14) Notwithstanding CONSAD's intuition, the truth most likely is that the rise in Canadian reserves reflects normal variations in success, which is highly random in the petroleum industry, as CONSAD recognizes elsewhere. (6.17) CONSAD also recognizes elsewhere that the decline in the United States ratio reflects technological change. (2.7)

CONSAD acknowledges that foreign oil cannot ordinarily be considered a substitute for domestic oil in the United States because foreign imports are restricted. (6.15) However, "Canadian (and Mexican) crude is exempt from allocation and licensing requirements of the Oil Import Program and, consequently, can serve as a substitute for domestic reserves for the individual producers." (6.15–6.16)

This comment is typical of the misconception about the economics of an industry which can arise from a cursory examination of its institutional constraints. The premise is technically correct, but the conclusion does not follow.

It has long been common knowledge that the amount of Canadian oil exports to the United States is limited by agreement between the two governments. Prime Minister Trudeau recently described this agreement:

"We have a continental oil policy of sorts that was set up in the past . . . essentially it means that Canadian oil producers sell to Western Canada and sell to the United States an amount roughly equivalent to the amount of oil that Eastern Canada purchases overseas and notably from the Venezuelan producers. It's a deal between the American Government and the Canadian Government which is cost-saving and for both parties." (*New York Times*, March 26, 1969, p. 14)

Canadian exports to the United States are, in fact, controlled, Hence, Canadian reserves are not substitutes for U.S. reserves; and CONSAD's mathematical conclusions accordingly derive from inappropriately combined reserve data.

The importance of non-substitutability becomes apparent when CONSAD tries to decide how much of a change in reserves to allocate to each country:

"The relative decline in each country would depend on whether the tax changes implemented in Canada were the same as those implemented in the United States." (8.11)

What CONSAD does not say is that tax treatment is *already* materially different in the two countries; hence, Canadian and United States reserves cannot be perfect substitutes. Indeed, how could CONSAD validly compute the effect of a U.S. tax change on total reserves in the two countries when U.S. tax treatment does not apply in Canada? When tax treatment differs to start with, one cannot possibly have the "same" changes in the two jurisdictions.

B. Unneutrality of the Corporate Income Tax

In its study, CONSAD takes the position that percentage depletion is an economically wasteful tax subsidy which leads to a mis-allocation of resources by encouraging over-investment in oil. CONSAD gives only five lines of text to the extensive discussion in the economics literature of the non-neutrality of a flat-rate corporate income tax, e.g., the work of Professor McDonald "who holds that a standard rate of corporation tax is not necessarily neutral in its effects on resource allocation and that . . . the depletion allowance may be found to be a neutralizing rather than a non-neutralizing factor." (5.33)

In our opinion, taxation of petroleum exploration and production at the standard rate would cause an unneutral and economically wasteful shift of resources *away* from this industry—an industry vital to the economic and military security of the nation. Tax provisions which counter the non-neutral effects of a flat-rate corporate income tax on a vital industry are *not* "tax subsidies"; they are justifiable provisions which prevent what would otherwise be economic inequities.[13]

Why do we believe that application of the standard corporate income tax rate to petroleum would cause an unneutral misallocation of resources? A flat-rate corporation income tax changes the relative attractiveness of different investments depending on risk and uncertainty, asset lives, and leveraging power. Investments in oil and gas exploration are characterized by high uncertainty, long asset lives, and low leveraging power. Thus, in the absence of mitigating provisions, one would expect that imposition of a flat-rate corporate income tax would divert resources away from petroleum exploration to other industries or to liquid investments.

Consider the following example of the unneutral effect of a corporation income tax levied at the same rate on two industries, "A" and "B." A is more uncertain than B, and we assume that investors demand twice as much cash generation to invest in A as in B, where the expected return is, say 10 percent in the absence of an income tax. This extra profit requirement in the event of success in A is compensation for the greater likelihood of failure in A. In each industry, we assume $100, 10-year investments yielding a constant annual cash flow which is reinvested in that industry.

The following tabulation summarizes the effect of a 50 percent income tax on the relative attractiveness of the two investments (first two columns):

CUMULATIVE CASH ON HAND AFTER 10 YEARS[1]

	No tax	With 50 percent income tax	With 50 percent income tax and percentage depletion at 50 percent of net income for "A"
A	$518	$250	$311
B	$259	$170	$170
Ratio A to B	2.0	1.5	1.8

[1] Includes earnings on project cash flow assuming it is reinvested in the same industry at the same rate of return.

The flat-rate income tax reduces the ratio of A to B from 2.0 to 1.5, thereby making A relatively much less attractive than B. Investors would, therefore, place their funds in B rather than A *because of the flat-rate tax.*

Since this mal-allocation of resources results from the tax, it is appropriate to correct it through the tax. The third column shows what would happen if A were entitled to percentage depletion at 50% of net income. The relative deterioration in its position would be mitigated, with the ratio at 1.8. Complete restoration of the original relative profit position could be achieved by also permitting A to accelerate the write-off of part of its $100 investment.

A third possible use of funds is liquidity. If returns are not high enough relative to liquidity, investors need not invest in uncertain projects at all. The following tabulation compares "A" with liquidity, e.g., leaving the $100 in a safe deposit box:

CUMULATIVE CASH ON HAND AFTER 10 YEARS[1]

	No tax	With 50 percent income tax	With 50 percent income tax and percentage depletion for A at 50 percent of net income
A	$518	$250	$311
Liquidity	$100	$100	$100
Ratio A to liquidity	5.2	2.5	3.1

[1] Includes earnings on project cash flow assuming it is reinvested in the same industry at the same rate of return.

[13] Percentage depletion is not, of course, a subsidy in any event because it is not a direct cash payment from the U.S. Treasury.

In this case, a substantial accelerated depreciation allowance would be required to re-establish the pre-tax ratio of 5.2.

It is apparent that the outcomes in the real world will vary with project lives, required relative profit ratios, leveraging power of the industries, etc. A recent extensive study using typical manufacturing and petroleum examples has shown that with *both* percentage depletion and the expensing of intangibles allowed to petroleum, the present corporate income tax results in roughly equivalent after-tax and pre-tax ratios.[14] Hence, these petroleum tax provisions tend to offset the otherwise un-neutral effects of a flat-rate corporate income tax.

Why does the flat-rate corporation income tax discriminate in this way against high-return investments? What matters in project profitability evaluation is the net cash which flows from operations (that is, gross receipts less operating expenses). *The flat-rate corporate income tax reduces this cash flow by a greater percentage in the case of the project with the higher cash flow.* The following tabulation shows the effect of a 50% corporate income tax on the annual cash flows required to achieve the stated profitability levels of A and B in the absence of a tax:

	A	B
Annual cash flow without tax	$22.3	$16.3
Less annual depreciation	10.0	10.0
Taxable income	12.3	6.3
Tax at 50 percent	6.2	3.2
Annual cash flow after tax	16.1	13.1
Percentage change in annual cash flow	−28	−19

These −28% and −19% tax-induced changes are minimal indications of the discriminatory effect of the tax, since the loss of future (compounded) earnings on the reinvested funds would also be larger for A.

Senator HANSEN. Let me, first of all, express my appreciation to you, Dr. Wright, for your presence here this afternoon. We have heard a great many witnesses. I believe that you may be the first one to testify today who has taken exception to a line generally followed by the witnesses in finding fault and criticizing the proposals coming from the House and from the Treasury Department, and I certainly will be taking time to study your testimony very carefully.

Mr. WRIGHT. Thank you.

Senator HANSEN. Let me ask you with regard to the CONSAD report. You have read the report, have you?

Mr. WRIGHT. Yes.

Senator HANSEN. Did you find any reason to criticize it?

Was it deficient in any of its conclusions or invalid in any of the premises that it assumes, as nearly as you could discern?

Mr. WRIGHT. I did not find it deficient in any premises or in any conclusions which were derived from the materials they analyzed. With the data problems that CONSAD encountered there would be criticisms which would be of an absolute rather than a relative sort, things that they simply could not grapple with, but, aside from that sort of hesitation, I would not have any disagreement with the report.

Senator HANSEN. You are familiar with the economic model that they constructed to try to project the impact that certain changes in the tax laws would have upon the availability of crude oil in the country, are you?

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[14] See Robert F. Rooney, *Tax Treatment and Regulation of the Domestic Crude Oil Industry*, unpublished doctoral dissertation, Stanford University, 1965.

Mr. WRIGHT. I am generally familiar with the type of model they used, yes.

Senator HANSEN. In your judgment, is there a relationship between the level of crude oil production and industry profitability? Would there be?

Mr. WRIGHT. There would be an indirect relation along with several other variables, yes.

Senator HANSEN. Generally speaking as an economist, would it be your feeling that profitability in any industry would encourage greater production and the failure to show a profit might discourage production? Would this be rather a simplification of the concept you hold, or do you subscribe to that?

Mr. WRIGHT. Well, economists think that industries which are experiencing declining profits tend to diminish in size, and those realizing high profits tend to expand, and these are the signals that the market works with, yes.

Senator HANSEN. I happen to be a cattle rancher. My experience has been that if the cow business, as an example, fails to show a profit, people will tend to leave that business and go into other areas of activity, and the net result will be diminution of production in the livestock business. On the other hand, if prices rise, breeding stock will be held back so as to encourage greater calf crop and generally will result in greater production. Would this illustration be typical in your judgment of the reaction of the business community generally, would you think?

Mr. WRIGHT. Insofar as the market is free to operate, you have stated that prices would rise if there were unsatisfied demands for this product, and this would encourage people to stop divesting themselves of full-grown stock and, then, subsequently, the supply of the industry would expand.

Senator HANSEN. Would you feel that the fact that the CONSAD report fails to take into account a relationship between the level of crude oil production and industry profitability might be reason to criticize the report?

Mr. WRIGHT. I have heard this statement in this room today for the first time, and I, frankly, do not understand what it means. Is this a particular assumption that you are talking about in the report? Is this how they failed to take this into account—I mean, the approach used did not explicitly rule out such a relationship as I recall. Could you clarify if that is what that statement means?

Senator HANSEN. I must say that I have not yet had time to read the CONSAD report word for word, but it is my understanding that the CONSAD report does fail to note and to reflect an interrelationship between industry profitability on the one hand and crude oil production on the other.

Mr. WRIGHT. The CONSAD report deals with the question of petroleum reserves and their relation, the level of these reserves, to the Federal tax program, percentage depletion, and intangibles expensing.

Now, there is some relationship, an economic relationship, between reserves and production. Perhaps, this relationship could enter through that indirect route; however, I have not felt, myself, that there was any, that this put any crimp in their style. So far as I could tell, they took adequate account of it, so that if it were not so for some reason, the results did not change that much.

Senator HANSEN. Let me ask you: Would you agree that if there was really little evidence of profit in the oil business would that tend to discourage people from going into the business?

Mr. WRIGHT. Evidence of profit as revealed in the stockholders' report, for example?

Senator HANSEN. Or in the experience of an independent oil operator?

Mr. WRIGHT. Including independents?

Senator HANSEN. Yes.

Mr. WRIGHT. Yes, if profits were declining this would indicate the sort of thing we talked about in the example of cattle ranching.

Senator HANSEN. And would it not follow that, if profits did decline, in the long haul that would tend to bring about the development of fewer rather than greater reserves?

Would this seem reasonable to you?

Mr. WRIGHT. Yes, this is what the market mechanism would be calling for.

Senator HANSEN. Thank you very much. I have no further questions.

Senator MCCARTHY. Thank you very much, Mr. Wright.

(Mr. Wright's prepared statement, with attachments, follows:)

STATEMENT OF ARTHUR W. WRIGHT, ASSISTANT PROFESSOR OF ECONOMICS, UNIVERSITY OF MASSACHUSETTS, AMHERST, MASS.

SUMMARY

States that the present tax treatment of natural resources is an important source of unfairness in the Federal tax system. Points out that the present tax rules for natural resources make it possible for many extremely wealthy individuals to pay less Federal taxes than persons living in poverty and enable corporations engaged in mineral production to pay far less Federal taxes than do other corporations.

Condemns the present tax treatment of natural resources as a wasteful and inefficient form of subsidy, the need for which has not been demonstrated. Suggests that the beneficiaries of mineral tax subsides should have more faith in the ability of the American free market economy to produce minerals and fuels without Federal aid.

Points out that the present system of mineral tax subsidies creates severe administrative burdens for government and business alike. Indicates that the areas of greatest administrative difficulty concern "economic interest" questions, depletion rate determinations, cut-off point questions, unit price computations, and the fifty percent net income limitation on percentage depletion.

Points out that the Treasury's CONSAD Report, published in March 1969 by the House Ways and Means Committee, constitutes the only thorough study, to date, of the effects of the present system of tax subsidies for mineral producers. States that the CONSAD Report shows the inefficiency of these tax subsidies. Also states that the CONSAD Report has withstood the criticisms leveled at it by the petroleum industry, and suggests that the industry should commission studies of equivalent stature and thoroughness rather than merely criticizing the CONSAD Report.

Rejects claims that natural resource producers pay their fair share of Federal taxes. States that claims of this sort often use misleading bases for comparison (such as gross income instead of taxable income) and inconsistently lump together foreign taxes, Federal taxes, local taxes, and user charges when computing the industry tax burden.

Also rejects claims that the present tax treatment of natural resources is needed to let natural resource producers recover their capital investment in mineral properties. Points out that this recovery can be accomplished through

cost depletion and that the present tax treatment is defective because it permits tax free recovery of amounts far greater than a mineral producer's original capital investment. States that this tax treatment discriminates against other industries that also must attract substantial amounts of capital investment.

Also rejects the claim that percentage depletion helps keep gasoline prices down. Points out that the Treasury recently estimated there would be a change in the price of gasoline of less than one half cent per gallon if the percentage depletion rate were reduced to 20 percent. States that retail prices of gasoline could be reduced by *several* cents per gallon by removing import restrictions and Federal support for market prorationing.

Also rejects mineral industry arguments that their tax benefits should be continued because industry rates of return on capital are low. Questions whether mineral industry rates of return are in fact low. Further states that rates of return, in the American free market economy, tend to equalize in all industries after taking into account the tax benefits granted each industry. Suggests that mineral tax benefits are often dissipated in the form of higher royalty payments to property owners.

Describes the present program of tax assistance to the natural resource industries as an inequitable, wasteful, problem-ridden government aid program. Urges the Committee to scrap the existing aid program and substtiute depletion computed on the basis of actual cost, together with capitalization of intangible drilling costs and recovery of such costs over the useful life of the property like business investment in other industries.

Praises the natural resources provisions in the House-passed tax reform bill as a step in the right direction, but criticizes both the House bill and the Administration's proposals for failing to eliminate percentage depletion entirely, and, most particularly, for failing to require full capitalization of intangible drilling and development costs.

STATEMENT

Mr. Chairman and Members of the Finance Committee:

Thank you for receiving this statement on tax reform in the area of depletable natural resources. This is an important subject, because changes in present federal tax treatment of natural resources ought to be part of any meaningful tax reform package. To facilitate my presentation, I have prepared a separate analysis in which my views on this subject are developed in more detail.* I would like to ask the Committee's permission to insert this analysis in the record following my written statement.

I represent no organization or interest group. Rather, I am writing as an economist and concerned citizen who has studied natural resource problems, including their tax treatment, for about a decade. As a result of my work, I have become increasingly worried about present federal tax policies in this area. Let me summarize the reasons for my concern.

1. *Lack of tax fairness.*—Present tax policies towards natural resources provide a major route by which wealthy individuals and corporations escape liability for federal income taxes. As a result, our tax system, judged by publicly accepted standards, is less fair than it should be. Understandably, the American public has become concerned about this situation.

2. *Waste of tax monies.*—The present tax treatment of natural resources leads to a serious waste of public funds, because we are receiving very little benefit in return for substantial tax expenditures. Moreover, our present tax policies make it harder to attain other worthwhile public goals, such as greater public confidence in our tax system.

3. *Administrative difficulties.*—Serious problems have arisen in administering the present tax provisions for natural resources. These problems have been unduly neglected in past studies of natural resource taxation. After forty years of court decisions, regulations, and rulings, these problems are now more serious than they were when the special tax benefits for mineral producers were first introduced.

I will discuss each of these points in turn.

1. *Lack of tax fairness.*—There are two standards by which to judge the fairness of the federal tax system.

First, taxpayers with similar incomes should bear similar tax burdens. The effective tax rate should not depend on the *source* of one's income: earnings from

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*The analysis referred to will be printed in the record compiled of the hearing.

minerals and earnings from other sources should be taxed alike. Yet earnings from natural resources are now taxed at lower rates—in many cases substantially lower rates—than earnings from most other sources. Under present tax rules, natural resource incomes are shielded by percentage depletion deductions in excess of cost depletion, by accelerated writeoffs of exploration and development expenditures—including, for petroleum and natural gas, immediate expensing of intangible drilling and development costs—and by inflated foreign tax credits.

A family with an income of $50,000 from (e.g.) oil production should, in fairness, pay about the same tax as a family with $50,000 in income from ordinary salary and wages, but the Internal Revenue Code's special provisions for natural resources make this impossible. Similarly, an oil firm should pay more than a tiny fraction of the corporate tax which is paid by a chemical firm with similar receipts and profits. Yet our present tax rules permit the oil firm and other natural resource firms to avoid payment of their fair share of federal taxes.

The second standard of tax fairness is progressivity of tax rates. This means that persons with higher incomes should be taxed more heavily than persons with lower incomes. But the present tax provisions for natural resources, by providing high income groups with an easy way to reduce their effective tax rates, make it very difficult to attain this goal. So broad is the avenue of escape that a significant number of wealthy individuals, including some with incomes in excess of $1 million per year, pay less federal taxes than do individuals living in poverty. The public is understandably concerned about such unfairness. If we fail to correct this situation, we run the risk of undermining the faith of the American people in their self-assessment tax system. In order to operate well, such a system must have public confidence.

These considerations of tax fairness argue for putting an end to the special tax privileges currently enjoyed by the natural resource industries. Unless this is done, it will not be possible to produce a tax system which, because it treats all taxpayers fairly, is entitled to widespread public support.

2. *Waste of tax monies.*—In the United States, it is our policy to rely primarily on market forces to achieve our economic goals. Government intervention in the marketplace is not favored unless it is found to be absolutely necessary. At present, however, the federal government actively intervenes in our market economy by exempting the natural resource industries from taxes they would otherwise have to pay. Is this government intervention necessary?

A number of traditional arguments have been advanced in support of the existing interventionist tax treatment of natural resources. Most of these arguments lack substance. For example, we are told that our present tax policies are needed to foster "a strong mineral industry." But why should we benefit the mineral industries at the expense of everyone else? The expansion and success of *all* our industries are important, and the mineral industries should have no special claim to government favor.

We are also told that natural resource production requires advantageous tax treatment because it is highly "risky". But those who have studied the petroleum industry—supposedly the most risky of all the natural resource industries—have pointed repeatedly to the ingenious techniques developed by oil and gas producers to spread risks within the market mechanism. Most pleas from oil and mineral producers for tax assistance show a disturbing lack of faith in the ability of market processes to adapt to risks. What is needed is more faith in the American market economy, and less reliance on public expenditures through the tax system.

The only possibly valid argument for retaining existing tax aid to natural resource producers is the so-called "national security argument." The heart of this argument is the claim that extra productive capacity—referred to as "reserves"—is needed for use in the event of war or other emergency, and that special tax benefits are needed to encourage the creation of such reserves. However, the national security argument is open to serious doubt on several counts.

In the first place, we do not really know whether the national security requires greater reserves than market processes, if left to themselves, would provide; or if there is a need, how great it is in quantitative terms. Secondly, we have no proof, beyond tub-thumping assertions by industry spokesmen, that present natural resource tax provisions actually do create significant additional reserves. The evidence we do have, from several non-industry sources, indicates that the net impact of our tax policies on reserves is rather small.

The most recent evidence on this subject was provided in the Treasury report prepared by the CONSAD Research Corporation and released in March 1969. The results of this report, which in my opinion remain essentially valid in spite of attacks by the Mid-Continent Oil and Gas Association and other industry groups, suggest that our present tax policies result in additions to petrouem reserves worth, at most, $150 million per year, in return for annual tax expenditures for petroleum exceeding $1.3 billion. Spending $1.3 billion through the tax system to achieve public benefits worth $150 million is a wasteful extravagance.

It is significant that during 1969, petroleum industry publicists have begun to de-emphasize the national security argument, and to play up the notion that special tax treatment of petroleum helps maintain low prices to consumers. This notion, and its implied corollary that removing such tax treatment would cause sizable price increases, have simply not been convincingly demonstrated. Nor has the industry explained why we should use the tax system to manipulate oil prices and not the prices of such other "vital" products as milk or clothing. Nor has the industry explained why we should bother to tax consumers of oil products more heavily in order to attempt to give them lower product prices.

If the industry were serious about reducing prices to consumers, they would be asking Congress to remove or greatly relax the present restrictions on oil imports, and seeking to do away with the various state prorationing schemes—just the opposite of their stands on these programs. Clearly the "low price" justification for special tax treatment of natural resource producers can be dismissed as merely another example of the cynical scare tactics employed so often in past industry publicity.

The Honorable Wilbur Mills, Chairman of the House Ways and Means Committee, in a speech to the House in December 1967, aptly labelled tax expenditures—that is, expenditures on the revenue side of the budget—as "back door spending." In this speech, Mr. Mills pointed out several defects of tax expenditures as opposed to outright appropriations: tax expenditures are seldom reviewed by the Executive Branch or by Congress to determine whether they are still necessary; accurate data on their costs and benefits are often difficult to obtain; and too frequently they are wasted on firms which would have undertaken the intended activity without them.

These defects obviously characterize our present system of tax expenditures on the natural resource industries. The basic philosophy of the system—that is, the long-term objectives, the need for tax benefits, and the rationale of the existing set of depletion rates and cut-off points—has escaped serious examination for 40 years. Furthermore, no line items in the Administration's budget reflect our tax expenditures on natural resources. And, as the recent CONSAD study suggests, most of these expenditures are wasted.

It is important to recognize the relative magnitude of our back door spending on natural resources. According to a statement on January 17, 1969, by former Secretary of the Treasury Joseph W. Barr, the United States currently spends—through the back door—at least $1.7 billion annually to aid oil producers and other segments of the extractive industries. This sum is just $200 million short of what the federal government appropriates directly, under close scrutiny, for the same purpose.

The $1.7 billion in back door spending on natural resources is three times what was budgeted during fiscal 1969 for federal law enforcement; fifteen times as much as the cost of running our federal judicial system; three times the budgeted amount for school lunch and food stamp programs; five times as much as is budgeted for low-rent public housing; and four times the allotment for the Alliance for Progress. This $1.7 billion in back door spending rivals in size such carefully scrutinized areas as the foreign aid program, the Apollo moon program, the programs of the Office of Economic Opportunity, and federal aid for elementary schools. Tax expenditures of this magnitude should be halted in the absence of solid proof that these huge expenditures actually produce public benefits commensurate with their size.

3. *Administrative difficulties.*—Too little attention has been paid to the serious practical problems encountered in administering our present system of special tax benefits for the natural resource industries. In part, these difficulties arise from taxpayers' natural desire to expand their tax benefits to the greatest de-

gree possible, and the equally natural desire of tax administrators to limit revenue losses. Difficulties also arise from the vagueness of the existing statute, which frequently fails to identify clearly the natural resources for which tax benefits may be claimed, or the rules to be used in computing the dollar amount of the tax benefit.

These problems are not simply a matter of percentage depletion rates, as is sometimes thought. The problems actually fall into five major areas. The first of these areas involves the taxpayer's possession of an "economic interest" in a natural resource property. An economic interest is a necessary prerequisite to a depletion claim, but there is much confusion regarding the legal meaning of this vague term.

The second problem area involves the appropriate percentage rate of depletion for a particular natural resource deposit. Different ores and minerals are entitled to sharply different depletion rates under the Code. However, because the Code's definitions are vague, and because deposits vary in physical and chemical composition, it is not always clear which rate applies to a particular deposit.

Third, many difficulties arise concerning the "cut-off point," which determines the amount of processing which a taxpayer may include in his depletion base. In general, the inclusion of more processing in the depletion base increases the depletion deduction. The principles to be used in determining an appropriate cut-off point are not clear, and disputes therefore abound.

Fourth, there is the problem of determining the unit price to be used in computing gross income from a natural resource property. For instance, I understand that the Internal Revenue Service has recently encountered major difficulties in determining the price for crude oil produced by U.S. firms operating out of the Persian Gulf. Similar pricing problems affect many other natural resources.

Finally, there are rather serious problems connected with the computation of the statutory fifty percent net income limitation on percentage depletion. Allocating costs between extractive and fabricating activities, and the carryover of losses from one accounting period to another, are patricularly vexing problems in this area.

Today, after 40 years of court decisions, regulations, and rulings, the practical problems in administering the tax provisions for natural resources are more serious than they were in the 1920's when these provisions were first introduced. The accounting and legal costs incurred in trying to cope with these problems are substantial, for government and taxpayer alike. It has been necessary to create an elaborate government bureaucracy to handle these matters, and businessmen are induced to spend time and energy in protracted disputes rather than in productive endeavors. Moreover, as technology and costs change, and as new types of natural resources come into use, new problems continually arise. The complexities involved in trying to settle these administrative problems further increase the waste and inefficiency associated with the percentage depletion mechanism.

Summary and recommendations

In short, our present program of tax assistance to the natural resource industries is an inequitable, wasteful, problem-ridden government aid program. Only one responsible recommendation can be made: this program should be scrapped. Depletion on natural resource properties should be computed on the basis of actual cost, under rules similar to those set forth under section 611 of the Internal Revenue Code. Future investments in natural resource production facilities should be capitalized, and, like business investment in other industries, recovered over the useful life of the property.

Recent action by the House Ways and Means Committee, recommending reductions in percentage rates of depletion and restricting the uses of several ploys that widen the tax loopholes on natural resource incomes, constitutes a step in the right direction. In my view, however, the Committee did not go far enough; moreover, they did nothing about the unnecessary and unparalleled provisions for immediate expensing of so-called "intangible" drilling sots—a glaring omission from what is otherwise a promising package of tax reforms.

If natural resource producers actually need government aid—and this need has not been satisfactorily demonstrated—there are cheaper, more effective means of giving such aid which would avoid the inequities and administrative difficulties of the present aid system. Specifically, direct appropriations, which are more easily scrutinized and more directly tied to performance, are a superior method of granting government aid.

In conclusion, I appeal to this Committee to scrutinize carefully the arguments advanced by natural resource producers in support of the back door spending now authorized by the special mineral resource provisions of the Internal Revenue Code. It is important to remember in making this examination that all of the available evidence indicates we are wasting tax money—huge amounts of tax money each year—through these special tax provisions. We are spending big sums but receiving little in the way of public benefits. Until these wasteful back door expenditures are brought to a halt, I believe that the public will be justified in regarding much of the talk about "tax reform" and "economy in government" as empty rhetoric.

Thank you.

Federal Tax Policy and the Natural Resource Industries: Are We Getting Our Money's Worth?

(Arthur W. Wright, Assistant Professor of Economics, University of Massachusetts)

INTRODUCTION

In this paper, I propose to evaluate, with the aid of economic analysis, the effectiveness of existing federal tax policy towards the extractive (natural resource or mineral) industries. This important area of public policy deserves careful scrutiny as a prime candidate for inclusion in any meaningful program of tax reform.

Through a set of special tax benefits, this nation now in effect spends large sums of public money each year on the extractive industries. As with any public expenditure, sound public policy requires continuous review by government bodies, raising and hopefully answering questions such as these: What benefits is the nation deriving from present "tax expenditures" on natural resources? Are they benefits we want? What are the costs of obtaining them (including other possible benefits foregone)? Could we achieve the same results more effectively or at lower cost with other programs?

After much study, I have concluded that the present tax benefits to mineral producers are poor public policy. The benefits are few, the costs high. Having examined the usual rationales for continuing present tax policy in this area, I strongly doubt that tax assistance is either necessary or desirable. Should the Congress decide that some form of special treatment is justified, there exist several alternatives to the present policy that would be both cheaper and more effective.

Following a brief outline of the principal tax benefits accorded to the extractive industries, five topics receive detailed discussion: (1) taxpayer inequities; (2) economic waste; (3) administrative difficulties (all too often ignored); (4) the relation of the tax provisions specific to the extractive industries to the general capital gains option; and (5) the proposed "minimum tax" system as a tool of public policy in connection with natural resource taxation.

Tax policy is of course related to other areas of public policy towards the extractive industries. The most notable example is in the oil and gas industry, which is affected by state regulation and federal import quotas as well as federal tax provisions. Although the ideal would be a complete treatment of all facets of public policy, attention will be limited here solely to tax policy except for an occasional footnote reference to the other facets.

I. Present Special Tax Benefits for the Extractive Industries

The Internal Revenue Code contains three basic special tax benefits for producers of petroleum, natural gas, and hard minerals. These are, first, the percentage depletion deduction set forth in section 613 of the Code; second, the special provisions in section 263(c) which permit the current write-off of intangible drilling and development costs in the case of producing oil and gas wells; and, third, the provisions contained in sections 615 through 617 of the Code which permit exploration and development costs to be written off currently, subject to certain limitations. In addition, section 1.612-4(b)(4) of the Treasury Regulations on Income Tax grants oil and gas producers who have elected to capitalize intangible drilling and development costs the additional option of either expensing or capitalizing their dry hole costs.

In addition to the benefits provided directly in the Internal Revenue Code and Treasury Regulations, there are important foreign tax credit benefits which have been extended to the mineral industries by revenue rulings on the foreign tax credit provisions set forth in sections 901 through 906 of the Internal Revenue Code.

The percentage depletion provision is an extraordinary tax benefit because it permits the tax-free recovery of dollar amounts which are greater, often far greater, than the taxpayer's original investment in a depletable mineral property For this reason, the percentage depletion deduction is a subsidy, not simply a mechanism for the recovery of a taxpayer's capital investment. In addition, that portion of the percentage depletion deduction which represents ordinary tax free recovery of capital investment costs is usually recovered more rapidly than would be the case if natural resource taxpayers were required to compute depletion analogously to the computation of depreciation in non-extractive industries. Percentage depletion therefore confers a double benefit: (1) deductions in excess of initial cost, and (2) deductions of initial cost that are unusually accelerated.

The intangible drilling and the exploration-and development provisions of the Code are both extraordinary tax benefits because they permit the immediate tax-free recovery of capital investments. In contrast, the tax-free recovery of capital investments in manufacturing, transportation, and most other industries is generally geared much more closely to the actual wearing out of capital equipment; for example, a producer of automobiles must depreciate his machinery over its useful life, a railroad must depreciate its rails over their expected life, and a farmer must take annual depreciation deductions on his farm equipment. Immediate, tax-free recovery of capital, such as the mineral industries enjoy is thus the exception rather than the rule.

The special percentage depletion rule, the special intangible drilling cost rules, and the special exploration and development rules all constitute departures from normal accounting procedures. This is the main reason why giant firms can regularly report handsome profits to their stockholders while paying little or nothing in Federal income taxes.

The foreign tax credit provides another important tax benefit for U.S. firms producing natural resources in other countries In the case of genuine income taxes, and taxes levied in lieu of genuine income taxes, these provisions probably do not confer special benefits on the mineral industries relative to other industries. However, petroleum, iron ore, and bauxite producers, among others, appear to have claimed the foreign tax credit for "taxes" which are actually paid in lieu of landowner's royalties. This has occurred particularly in the Persian Gulf region, where the landowner and the taxing authority are frequently one and the same person. In that region, landowner's royalties originally charged by the feudal Arab kings have generally been converted into so-called income taxes, which have been ruled creditable for Federal income tax purposes, Revenue Ruling 55-296, 1955-1 Cum. Bull. 386, for example, held the Saudi Arabian "income tax" to be creditable against United States income taxes. The effect of rulings such as this has been to confer substantial benefits on both the oil producing nations of the Persian Gulf and the international oil companies at the expense of the United States Treasury. In addition, these benefits discriminate against domestic United States producers, because a tax credit is being allowed for an item which is actually just a normal business expense and which is not creditable against tax for domestic United States producers.[1]

There is some disagreement over whether the option of currently expensing "dry hole" costs in petroleum drilling represents special tax treatment. On the one hand, it can be contended that dry hole costs are losses which should be currently deductible like other business losses. On the other hand, they may be viewed as part of a capital investment program, the object of which is the acquisition of assets in the form of reserves. The former position seems consistent with present general corporate income tax procedures, whereas the latter is more relevant for economic theory.[2] Since this paper will focus on evaluating the special

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[1] Domestic U.S. producers are of course protected by the reverse discrimination against foreign sources inherent in the oil import quotas imposed beginning in 1959.

[2] See McDonald 1967, p. 269 n. (The full citations corresponding to the abbreviated references used in the footnotes can be found in the bibliography at the end, listed alphabetically according to the abbreviated forms.)

tax provisions for natural resources relative to the uniform corporate income tax, we shall not regard the current expensing of dry-hole costs as a special provision.

II. Taxpayer inequities

As I read it, the generally accepted view of taxpayer equity, or fairness, implicit in federal tax policy consist of two standards: Taxpayers with similar incomes should bear similar tax burdens ("horizontal" equity). And the effective structure of marginal tax rates should be "progressive", that is, persons with higher incomes should be taxed proportionately more heavily than persons with lower incomes ("vertical" equity).[3] These principles apply to corporations as well as individuals, although the progressivity of effective corporate rates is quite weak, arising only from the lower rate applied to the first $25,000 of corporate income.

Recent studies by the U.S. Treasury Department have suggested that the present tax system, when measured against these two standards, contains numerous and large inequities. These studies make clear that the special tax treatment of the extractive industries is a major source of these inequities, for both individuals and corporations.

Horizontally, these studies find that effective tax rates vary widely among individual taxpayers having similar adjusted gross incomes.[4] Parallel variations are found between sectors of industry, although variations among corporations *within* a given sector are presumably smaller.[5] Present tax treatment of the extractive industries fosters such variations by distinguishing between *sources* of income. One's effective tax rate should not, in fairness, depend upon the source of one's income. Earnings from natural resources and earnings from other sources should be taxed alike. Yet the former are now taxed at lower rates—in many cases substantially lower rates—than earnings from most other sources. Under present tax rules, natural resource incomes are shielded by depletion deductions in excess of cost depletion, by accelerated writeoffs of exploration and development expenditures (including, for petroleum, immediate expensing of intangible drilling costs) and by inflated tax credits.

Vertically, the Treasury studies find numerous instances of sharply reduced progressivity in effective tax rates. Present tax provisions for natural resources, among other provisions, contribute in a major way to the reduction by providing high income groups with an easy way to escape higher marginal rates. So broad is the avenue of escape that a significant number of wealthy individuals, including some with incomes in excess of $1 million per year, pay less federal taxes than do individuals living in poverty.[6]

A number of objections have been raised to the charge that inequities arise from existing tax provisions for natural resources. Some representatives of the petroleum industry—which accounts for "about 80 percent of the tax relief for extractive industries"[7]—complain of "unfair tax burdening" and insist that "contrary to popular claims, oil's total tax bill equals that of other industries."[8] The complaint of unfairness, which allegedly arises from "diversion" of the proceeds from "user taxes" on petroleum products,[9] is transparently hollow: the "use" involved is use of highways, not petroleum products. (If anything, the petroleum industry benefits from the tying of gasoline and Diesel fuel taxes to roadbuilding—a privilege not extended to (say) camping equipment taxes for campsites, picnic basket taxes for picnic areas, or liquor taxes for taverns—which increases the demand for their products.)

The petroleum industry's "total tax bill" is generally computed as the sum of all domestic income taxes (including those levied on employees' incomes), foreign taxes, so-called "severance" taxes, property taxes and excise taxes. (One industry protagonist has ever proposed including excise taxes on consumer

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[3] For example, *Tax Reform Studies*, 1969, Part I, p. 73.

[4] *Ibid.*, pp. 74–95.

[5] *Ibid.*, pp. 99–101. See also Senator Proxmire's speech to the Senate on January 22, 1969 (*Congressional Record*, p. S767). Note that provisions such as percentage depletion which apply only if a corporation has net income give greater tax benefits to corporations making money.

[6] *Ibid.*, p. 8; see also former Treasury Secretary Barr's statement to the Joint Economic Committee, January 17, 1969.

[7] *Ibid.*, p. 101.

[8] The first quote is from *The Oil Daily*, February 19, 1969, p. 1, and the second from *Oil and Gas Journal*, February 10, 1969, p. 27.

[9] *The Oil Daily*, February 21, 1969, p. 1.

goods purchased by industry employees.[10]) Clearly the total tax bill is a meaningless concept as it stands, and the asserted claim of equality (absolute? relative?) with those of other industries is just as meaningless. Foreign "taxes" (which in many cases used to be called royalties) do not pertain to the industry's contribution to domestic public treasuries. Excise taxes on petroleum products, generally earmarked for highway construction, seldom enter general funds, and are offset for comparative purposes by excise taxes on other industries' products. Taking away these two items, and noting the further offsets on employees' income taxes and on property taxes, we are left with the insignificant severance taxes and the industry's very low corporate income taxes.

A second, more general objection to the inequity charge is more substantial. The central idea is that the market mechanism will permit income recipients in the long run to adapt to tax provisions in such a way that the after-tax distribution of income is very similar to what it would have been without the provisions.[11] The alleged adaptation is made (for instance, in the case of the percentage depletion allowance) through the bidding up of the prices of assets whose incomes are subject to advantageous tax treatment until marginal after-tax returns are equated.

The market-adaptation argument has some validity with regard to horizontal equity, allowing for differences in peoples willingness to expend time and effort (or money, on a good tax lawyer) to study the tax laws. Such barriers as exist for one millionaire but not for another seem to be relatively insignificant. But this argument cuts two ways: While it tends to weaken the charge of horizontal equities arising from special tax provisions, it also weakens the possible objections to removing those same provisions. The market is equally good at doing and undoing.

When it comes to vertical equity, however, the market-adaptation argument is not valid. Present special tax provisions applying to natural resources (along with most other alleged loopholes) are not attractive until one enters a fairly high tax bracket, i.e., until one's income reaches a high level. (A reasonable guess at the minimum threshold might be $25,000 of gross income per year.) These provisions therefore represent an opportunity—the progressive rate structure itself providing the incentive—to higher-income groups to reduce their share of income paid in taxes relative to lower-income groups, and relative to the effective rates intended in the Internal Revenue Code. Moreover, it is precisely persons with higher incomes who can afford to strive to expand the coverage of special provisions. (The ample efforts so to widen the "loopholes" is a testimonial of sorts to the vigor of market responses in the American economy; unfortunately, under present tax rules this vigor is not channelled into producing more goods and services.)[12]

Up to now I have dealt solely with the effects of special tax benefits for the extractive industries on the size distribution of income among individuals and among corporations. Those benefits would also affect the distribution of so-called "functional" shares of total income accruing to the various factors of production and residual claimants. The fact that natural resources are extracted from the ground, together with U.S. institutions of private property makes incomes associated with land ownership—lease payments, land sales and production royalties to land owners—an important element in functional income distribution. The effect of existing tax provisions for natural resources is to raise these incomes; conversely, the effect of removing or partially reducing the dollar magnitude of the existing provisions would be to lower land incomes.[13] The quantitative extent of the change (which is of a once-for-all sort in either direction) would depend upon the distribution of possible resource-bearing lands ranked according to natural resource content and accessibility (including location in relation to markets). The fewer the good ones, the greater would be the change.

The impact of a given change in the functional share of land rent on the size distribution of income (i.e., who would benefit or suffer from more or less favorable tax provisions) would depend on the pattern of land ownership.

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[10] Fernald in *Federal Tax Policy* 1955, pp. 427–428.

[11] For example, Henry Wallich, "Taxes and the Market," *Newsweek*, February 24, 1969, p. 78.

[12] Gray in *Federal Tax Policy* 1955, pp. 430–431, concisely documents the pressures over the years to secure more and more favorable treatment.

[13] At least in petroleum, production royalty percentages appear to be rather insensitive to changes in land values, most of the variation taking place in lease payments and land sale prices.

The same generally accepted standards of equity invoked earlier would apply to the problems raised in making the transition from preferential to equal tax treatment of mineral producers. Investors who had acquired mineral assets under the expectation of continued special tax provisions would be faced, when those provisions were rescinded, with "windfall" reductions in asset values. The remedy is simple: permit those investors to continue to receive the former special tax treatment *on those assets* until they are retired. The effective cut-off date should be set at about the time the Congress begins drafting legislation to rescind the special provisions, since subsequent to that time investors' expectations would be geared to normal provisions.

The public is understandably concerned about the unfairness created by present special tax provisions for natural resource and certain other sources of income. Their concern is increased by warnings from Budget Director Mayo of the possible need for new tax revenues over and above the ten percent surcharge still in effect.[14] Newspaper reports tells of the "millions in need of [tax] relief and the thousands who . . . enjoy tax privilege as a way of . . . life,"[15] and wonder how "such a tempting package of revenue goodies [the special tax provisions for oil and gas] survived the Vietnam tax squeeze without serious challenge."[16] Similar thoughts have undoubtedly occurred to taxpayers.

If we fail to correct the present inequitable situation, we run the risk of undermining the faith of the American people in their self-assessment tax system.[17] In order to function, such a system must have public confidence. More generally, at the present time any step that would strengthen the confidence of the people in the federal government is worthy of study.

III. *Economic Waste*

Considerable controversy has arisen over the relation of the special federal tax benefits for the extractive industries to economic efficiency. Much of the debate has been academic, confined to the pages of professional economics journals. Some of it, however, has reached the real (or near-real) world of Congressional hearings and other confrontations between the interested parties. Reading through the ample literature on the debate, I have been most impressed by the lack of communication between the contestants, be they representatives of academe, industry or the Legislative Branch.

Consequently, in the hope of clarifying the issues, hazarding some answers, but most importantly improving communication, I shall take a tack in this paper somewhat different from past presentations by economists. The approach employed here will build on the notion of public policy as set forth in the Introduction: Are we getting our money's worth from our considerable "tax expenditures" on natural resources?

Let us begin by examining how these tax expenditures work. The existing package of extractive industry tax benefits consists of tax credits. Tax credits can be called *general* policy tools, that is, benefits are paid through credits against tax liabilities which can be claimed for *any* activity that qualifies under the provisions. Expenditures from direct appropriations, by contrast, can be made as narrowly selective, or as broadly general, as the policy making body wishes.

A public policy aimed at stimulating activities that are already going on should be aimed at inducing business firms to begin operations which in the absence of the policy they would not have found worthwhile. In the jargon of economists, a policy of this sort should seek to influence business decisions "at the margin", or to be more precise, to extend the effective margin of economic operations.

Selective policies can be fairly well tailored to impart this kind of stimulus. However, general policies such as tax credits operate not only at the margin—by

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[14] In his statement to the Joint Economic Committee on February 18, 1969, reported in *The Oil Daily*, February 19, 1969, p. 1. According to Mayo, the estimated discrepancy after the 10 percent surtax is some $2.9 billion. Almost four-fifths of this discrepancy could be made up by removing the special tax benefits for natural resources, initially worth in excess of $2.25 billion according to Treasury figures (*Tax Reform Studies* 1969, Part 3, p. 41).

[15] *Newsweek*, February 24, 1969, p. 70.

[16] William K. Wyant, Jr., in the *St. Louis Post-Dispatch*, February 1, 1969, Editorials p. 1.

[17] Representative Byrnes has warned that "the whole [tax] system will become a victim to a lack of confidence and abuse" unless steps are taken soon (quoted in *Newsweek*, February 24, 1969, p. 66). The *New York Times* has recently editorialized in the same vein (January 10, 1969).

raising the after-tax returns of some previously sub-marginal activities—but on *all* operations. The benefits from a tax credit accrue to all operations, including those that would have been undertaken without the tax credit. In effect, businesses receiving tax credits are given a tax bonus for doing what they would have done anyway.

Such a bonus may not be entirely without results. For instance, depending on the precise form of the tax credit, the time rate of operations of previously existing activities may increase. However, such results need not be consistent with the intentions of public policy.

From the preceding analysis we would expect the present package of tax credits for mineral industries to encourage the opening up of marginal deposits of natural resources which would not have been worthwhile (at prevailing prices) if normal corporate tax provisions applied. Because a tax credit is a general tool of policy, however, benefits also accrue to owners of deposits that would have been in operation without a credit. As a result, only a portion of the tax benefits paid to natural resource producers goes into net stimulation to find and open up marginal deposits.

Because the main tax deduction for the extractive industries, percentage depletion, is computed on the basis of extracted output, there is also an incentive to produce at a faster rate per unit time from a given deposit—subject to the fifty percent net income limitation and to downward pressures on product prices as a result of all producers responding to the incentive.[18] It is not clear that an increased time rate of use of natural resources is necessary or desirable from the standpoint of public policy; for at least one goal (national security—see below) it is undesirable.

Economic analysis leads us, therefore, to conclude that present special tax treatment of the extractive industries would tend to stimulate the finding and opening up of marginal deposits, but in addition it would also aid operators of deposits which would have been explored and opened up in any case. Economic analysis also tells us that this special tax treatment would tend to increase the time rate of natural resource production, thus depressing current relative to future prices, a consequence which may not be desirable. The next step is to look at the extent of the total stimulus, its cost, and therefore its relative desirability from the standpoint of public policy.

A. Magnitude of tax benefits and results in the extractive industries

This is an area about which our quantitative understanding is still rather weak. Spokesmen for the extractive industries, who presumably would have the easiest access to empirical evidence, have never to my knowledge seriously attempted to quantify either the value of their tax assistance or the worthiness, if any, to the public of its results.[18a] Several academic students of the tax treatment of natural resources (mainly petroleum) have made estimates of the size of the money stimulus *at the margin*, but have not attempted to convert that into a total by estimating the impact on output.[19]

Fortunately, several studies recently released by the U.S. Treasury provide what seem to be reliable, up-to-date estimates of the size of present tax benefits to the extractive industries generally,[20] and of the size of the stimulus to creation of new reserves of petroleum in particular.[21] Tax expenditures due to the excess

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[18] McDonald 1967, p. 282 argues that the incentive to speed up the time rate of exploitation of mineral deposits would be "swamped" in the case of new deposits by another alleged consequence of percentage depletion, namely, a "reduction in the rate of interest . . . employed in choosing the optimum time distribution of production in newly discovered [petroleum] reservoirs." That rate of interest would, however, be determined in the capital market as a whole, not in the mineral sector alone. Hence the adjustment towards equilibrium in minerals would take the form of expanding the margins of production until marginal returns were consistent with the prevailing market interest rate and other prices.

[18a] The Mid-Continent Oil and Gas Association recently (April 1969) assembled a task force of economists to criticize the Treasury's "CONSAD report" (see note 21), but regretably did not instruct this task force to undertake an original analysis to replace CONSAD's findings.

[19] Harberger in *Federal Tax Policy* 1955; Steiner in *Tax Revision Compendium* 1959; *idem.*, 1963 and 1964. For a dissent to the Harberger and Steiner findings, see McDonald 1961, 1962, 1964 and 1967; note that McDonald's dissent has progressively weakened with time. See the next section for further discussion of this debate.

[20] Former Secretary of the Treasury Joseph W. Barr, *Statement before the Joint Economic Committee* 1969, Appendix p. 11; see also *Tax Reform Studies* 1969, Part I, pp. 101 ff.

[21] CONSAD 1969; see the comments on this report in *Tax Reform Studies* 1969, Part 3, pp. 413 et passim.

of percentage depletion over cost depletion, plus expensing of exploration and development costs are estimated to run currently at an annual rate of $1.7 billion.[22] Of this total a little over eighty percent, or about $1.4 billion, is estimated to go to the oil and gas industry.[23]

Regarding the results achieved with these tax outlays, the CONSAD study concluded that the special tax treatment of oil and gas achieved additional reserves, relative to the situation without such special treatment, worth at the most) $150 million at current prices.[24] Even allowing for a price increase of $1.00 per barrel if both percentage depletion and expensing of exploration and development costs were removed,[25] this is a poor return on tax expenditures of $1.4 billion.

As was noted earlier, percentage depletion operates directly upon current extraction but only indirectly on the finding and preparation of new reserves. Under present tax provisions petroleum is the main mineral to receive tax aid which directly affects pre-extraction outlays, namely, the privilege of immediately expensing so-called "intangible" drilling costs. There is no hard evidence here, but economic theory strongly suggests that the impetus from tax assistance as presently constituted to explore for and develop new deposits is even weaker for non-petroleum minerals than it is for oil and gas.

B. The desirability of tax assistance for the extractive industries

In the United States, government economic policy is founded on a premise of primary reliance on market forces to allocate scarce economic resources. Government intervention in the market place is reserved for instances where it is deemed highly necessary or desirable. We saw in the preceding section that at present the federal government actively intervenes in the American economy, to the tune of some $1.7 billion annually, by exempting firms in the extractive industries from taxes which they would otherwise have to pay. The public policy question should therefore be posed: Is this intervention through tax expenditures necessary or desirable?

1. The "McDonald debate" on tax neutrality

Communication will be improved between all interested parties if we clarify one potentially troublesome issue immediately. Over the past fifteen years a group of economists, led (and spurred on) by Stephen McDonald, have vigorously and at times heatedly debated whether the present tax treatment of natural resources is "neutral." [26] The neutrality at issue in this debate is whether the allocation of resources (in the economy as a whole, not just in the extractive sector) under present provisions is the same as would prevail *in the absence of any corporate income tax.*[27] Present provisions would be neutral if the two allocations are the same, and non-neutral if they differ. Note that the conclusion reached, be it neutrality or non-neutrality, is devoid of public policy significance as posed in the McDonald debate. Nothing is said about the desirability of either the no-tax or the special-tax-treatment allocation. Failure to appreciate this point, a failure to which even (or perhaps especially) economists are prone, can lead to overly hasty conclusions of "inefficiency" or "distortion".

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[22] Barr, *op. cit.*, p. 11, Table 4. The transitional first-year revenue effect would be greater by roughly a half billion dollars.

[23] *Tax Reform Studies* 1969, Part 1, p. 101.

[24] *Ibid.*, Part 3, pp. 427–428. Even if the CONSAD estimates are off by a factor of three or four, "the payoff for the revenue foregone . . . would be low . . ." (*ibid.*, p. 42). This source terms the CONSAD findings "broadly consistent" with earlier results, employing different but not contradictory methodology, obtained by F. M. Fisher (1964) and Erickson (in an unpublished Ph.D. thesis written at Vanderbilt University.

[25] Tax Reform Studies 1969, Part 3, p. 418, gives an upper figure of $0.95 per barrel on a current price of about $3.00.

[26] The debate has dealt only with petroleum, but the various arguments apply, with appropriate modifications, to the other extractive industries.

[27] McDonald points out (1962, p. 314 n.) that this is the proper comparison, for economic analysis. Our comparison, however, has been between a uniform corporate income tax and the present set of special natural resource provisions. This is the appropriate comparison for public policy, at least in present context.

The course of the McDonald debate is too long and involved to set forth here.[28] The present state of the debate is as follows. The non-neutrality, relative to a no-tax situation, of a uniform corporate income tax, is generally accepted. It is agreed that restoration of neutrality, short of rescinding the corporate income tax, would require some mechanism whereby firms in relatively capital intensive industries would be taxed at effective rates below the uniform rate; *and* firms in relatively non-capital-intensive industries would be taxed at rates higher than the uniform rate. Most recently, McDonald has come to the view that the present level of percentage depletion deductions, *plus* the tax benefits from being allowed to expense intangibles for tax purposes, would be several times too large to restore neutrality.[29]

Two points need to be made, for present purposes. First, no-tax neutrality may or may not be a sound goal of public policy; therefore, the policy implications of the non-neutrality finding *per se* are *nil.*[30] If it were decided that tax neutrality was a desirable policy goal, and even if McDonald's initial, coincidental finding that percentage depletion restored neutrality for the petroleum industry were correct, it would still be incorrect to conclude that the percentage depletion allowance was a sound tool of public policy. This is so because, by McDonald's analysis, the corporate income tax would be non-neutral for any and all capital intensive industries, and petroleum is not the only such industry. (Nor is it the only industry plagued by high risks, but more on that score later.) Further, McDonaldesque neutrality would require counterpart *increases* in the effective rates of corporate tax applied to industries with relatively low capital intensity—the equivalent of a percentage depletion surcharge on tax liabilities in those industries. Since no practical proposals for a perfectly differentiated corporate income tax have come forward, it is safe to conclude that the present significance for public policy of the McDonald debate on tax neutrality is very small.[31]

2. Traditional arguments for special tax treatment of natural resources

Over the years the special tax benefits paid to mineral producers have come under a number of attacks. In the course of defending their special treatment, and in the course of continuously pressuring the federal government for wider and yet more favorable treatment,[32] representatives of the mineral industries have advanced a host of arguments to justify their position. It is saddening to report that these arguments, which by now have attained the status of tradition by reason of frequent repetition, show more persistence and ingenuity in defense of special privilege than evidence in support of sound public policy.[33]

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[28] The first shots were fired, unwittingly, by Harberger (*Federal Tax Policy* 1955) and Steiner (*Tax Revision Compendium* 1959), who concluded that the distinctive tax benefits accorded to petroleum producers were non-neutral because they made it worthwhile to invest more per marginal dollar of return in petroleum than in less favored industries. The battle lines were drawn by McDonald (1961), who showed that under certain plausible (to him) assumptions, including perfect forward shifting of the burden of the corporate income tax from producers to consumers, the corporate income tax was not neutral, but rather discriminated against the more capital intensive industries and/or the riskier industries. Since petroleum is included in this group of industries, he argued, it was subject to tax discrimination. McDonald, not content with this result (with which others have concurred, e.g., M. Krzyzaniak and R. Musgrave, *The Shifting of the Corporate Income Tax* (Baltimore: Johns Hopkins Press, 1963), went on to attempt to show that the effective rate of percentage depletion enjoyed by the petroleum industry, about 22 percent, just about coincided with the reduction of the corporate income tax necessary to restore no-tax neutrality. (Intangibles expensing was not included in McDonald's calculations.) This argument elicited a critical comment by a Treasury economist, Eldridge (1962), and a major attempt by Steiner (1963) to refute McDonald's argument and to reinstate his and Harberger's finding of non-neutrality. A further exchange between McDonald and Steiner occurred in 1964. The latest published version of McDonald's position appeared in 1967.

[29] McDonald 1967, p. 286.

[30] McDonald acknowledged this point in his initial article (1961) and has since made it more explicitly and emphatically (1962, 1964).

[31] Musgrave (1962) along with others has pointed out that a value-added tax or, what comes to the same thing, a uniform *ad valorem* tax on all factor incomes, not just that of capital, would be no-tax neutral. The value-added tax has received some support, e.g., from the C.E.D., in recent years.

[32] For an account of the pressures to enlarge the scope of the percentage depletion deduction, see Gray in *Federal Tax Policy* 1955, pp. 430ff.

[33] Gray (*op. cit.*), cites the "ingenious arguments" that have gone into building an *ex post facto* rationale whose purpose is to "reconcile private privilege with the public interest." The ingenuity of oil lobbyists is reflected in their recent inclusion of the balance of payments problem in the case for restricting oil imports (*The Oil Daily*, February 24, 1969, p. 1).

(If I had to grade the industries' performance, they would receive an A for effort, B+ for ingenuity, and D+ for content.) Moreover, these arguments evidence little faith in, or else small understanding of, the prowess of the unfettered market mechanism in allocating scarce resources to their most productive uses. It is surely a rarity indeed to find an Eastern academic economist berating American businessmen for disparaging the market mechanism. But on most of the points raised by mineral industry spokesmen in support of government intervention in the market place, the market would perform the required tasks unaided, and perform them better than it can under the burden of present mineral tax policy.

The traditional justifications of tax aid to the extractive industries can be grouped into four broad categories, listed below in ascending order of substance, but descending order of frequency:

1. scare tactics
2. inflated rhetoric
3. peculiarities of natural resource production
4. national security.

The first two categories, which often overlap, need not be treated in detail here. Scare tactics range from dire warnings of having to strive "desperately for food and bare subsistence" without mineral supplies, through the risk of losing "untold millions of barrels of oil in less obvious formations" if the oil industry went "out of business," to the "ultimate nationalization of the oil industry" and an "onrushing energy gap" if percentage depletion were removed.[34] A characteristic feature of inflated rhetoric is that it can only be countered by resort to further rhetoric, or else by undertaking major research. Thus, assertions abount to the effect that the present system of tax aid to natural resources has (singlehandedly) produced a "strong, healthy" and even "dynamic" mineral industry "with a marvelous record."[35] Also, our policy of tax assistance to energy producers has "brought the American consumer the lowest energy costs in the world."[36]

The latter assertion provides enough of a handle to permit us to get a grip on it. First, note that the American consumer is also the American taxpayer, and as such he pays part of his *total* energy costs through the revenue side of the federal budget. Second, the governments of most West European countries, which have "high energy costs" (prices), achieve the high prices by imposing heavy taxes; the proceeds of these taxes go into the general fund (and not solely into a highway trust fund) to be used for the benefit of energy consumers. Third, comparing our energy costs with those of (say) the British is like a man bragging that he is stronger than an infant. We may be obtaining lower-cost energy than British coal, but doing better than one's least efficient rival is not necessarily the same thing as doing the best one can. The thrust of many remarks in this paper, along with those of other economists,[37] is that this nation does not appear at present to be buying energy at anywhere near the cheapest possible cost.

Turning to the third set of traditional arguments for tax assistance to the extractive industries, natural resource production is alleged to have two features which other industries lack, and which supposedly justify special tax relief: investments in mineral deposits yield "wasting" assets that are "nonreproducible"· and mineral resource investments, especially in exploration, are exceptionally "risky." Each feature is examined in turn.

The use of a separate term, "depletion," in place of "depreciation," to denote the using up of a natural resource asset reflects the alleged peculiarity of "wastingness." Natural resource assets, as opposed to those of other sectors of the economy, are said to waste because "the mineral sold is [physically] a part of the asset."[38] Once the natural resource is gone, there is nothing left. By contrast, the argument runs, a machine tool simply works *upon* other materials in a manufacturing process and is never actually sold as a part of normal business. But this concept of a "wasting" asset is neither economic nor accounting, but physical. One buys *any* economic asset for the time stream of productive

[34] The first three quotations are from *Federal Tax Policy* 1955, pp. 428, 481, 486 and 488 respectively; the last is from *The Oil Daily*, February 24, 1969, p. 1. Note the adaptation in the last quotation to contemporary scare-tactic usage.

[35] *The Oil Daily*, February 19, 1969, p. 1; *Oil and Gas Journal*, February 10, 1969, p. 7.

[36] *Oil and Gas Journal*, February 10, 1969, p. 7.

[37] For example, Adelman 1964; McKie and McDonald 1962.

[38] Fernald in *Federal Tax Policy* 1955, p. 419. See also Stanley in *ibid.*, p. 474.

services it will hopefully yield; whether it dwindles in physical volume or weight is of no concern whatsoever. Similarly, an accountant keeps track of the gradual wearing out of an asset's ability to contribute to saleable outputs. If the asset is a machine, as it deteriorates it begins to produce more rejects and is more costly to operate; if it is a natural resource, it begins to yield less pure material or to require larger inputs per unit extracted to obtain the mineral from less accessible areas in the deposit. A physical feature of production is a red herring so far as tax policy is concerned.

Regarding the allegation of "nonreproducibility," on the surface it is quite plausible that a mineral asset cannot be replaced or "reproduced" in the same way that a piece of equipment can. With the latter, it is simply a matter of tearing out the old and installing the new; but once a mineral deposit is "worked out," it can not be refilled with mineral. Hence, we are invited to conclude, owners of natural resource assets deserve tax assistance in replacing their assets when they are "depleted."

But such a conclusion, like the "wasting" asset argument, rests on a physical, not an economic or accounting relationship. The only sense in which any asset is "reproducible" is physical: given the blueprint, the materials and tools, and the space, it is possible to duplicate a piece of equipment within a very small range of error. But in an economic sense, one never "reproduces" an asset; rather, one buys a new or at any rate a different one: machine tool, coal mine, hot dog stand, and so on. It is possible to duplicate non-natural resource assets in every detail, including location, but the number of instances in which this happens in a modern economy, where an asset of any great size is involved, must be very few. So few, in fact, as to make any disadvantage to owners of mineral assets negligible. Furthermore, if there are disadvantages, the market will quickly pick up the appropriate signals and make an adjustment. As with "wasting" assets, so with "nonreproducibility" the conclusion is that the argument is without substance.

Let us now examine the allegation that mineral producers operate under exceptionally high risks, and therefore deserve compensatory tax relief. "Risk" refers here to all manner of multiple possible outcomes, regardless of the state of information about how those outcomes are distributed. The risk justification for special tax favors has been advanced by highly respectable people,[39] and the fact of high risk if not the justification is usually accepted uncritically by economists studying natural resource economics.[40] It therefore merits scrutiny. Looking ahead, however, after examining the various aspects of the risk justification, I have come to the conclusion that the true degree of riskiness in mineral production is greatly overstated; that where there are risks—in non-mineral as well as mineral industries—the market mechanism and the uniform corporate income tax can be relied upon (if not otherwise fettered) to spread risks successfully among different economic agents, thereby significantly reduced the risks to any single person; and that the single component of present mineral tax assistance with the largest dollar volume, percentage depletion, does not even help reduce risks. My over all conclusion is that riskiness can not be used to justify tax expenditures on natural resources.

Allegations of riskiness usually refer primarily to the exploration stage of natural resource production, and to certain specific industries: oil, natural gas, and sulfur.[41] The typical unit used in the risk allegation is the single-"shot" or "wildcat" drilling venture, which presently in the United States has a likelihood of succeeding (i.e., of finding a profitable deposit) of only 1 in 10 or 11.[42] This figure is supposed to depict the high risks associated with drilling exploratory wells.

What the figure of 1 success in 10 or 11 tries really to depict is the high risks associated with drilling a *single exploratory well*. If the Congress deems this a worthy enterprise, then more tax assistance than are provided by percentage depletion and quick expensing provisions is called for. Subsidizing the drilling of a single well would, however, be subsidizing a nonsnesical business practice. Businessmen in the riskier mineral industries seem to agree with this point, because virtually no one formulates a business plan (including financing)[43]

[39] For instance, Paley 1952, Vol. I, pp. 33ff.
[40] For instance, McDonald 1961 *et seq.*; McKie and McDonald 1962.
[41] Stanley in *Federal Tax Policy* 1955, p. 483.
[42] More correctly, only nine or ten of every hundred ventures succeed.
[43] Providing financing for a single, unaided "shot" would be a nonsensical banking practice.

consisting of a single "shoot", without first trying to assure himself of adequate cash flow to avoid liquidation if the "shot" misses. That cash flow guarantee is typically obtained by "farming out" producing "interests" in whatever discovery results from the venture—including zero commercially viable reserves.[44] Each holder of a patricipating interest presumably would purchase a number of similar farm-outs from other ventures to avoid a cash flow crisis himself. Among the participating interest holders generally is the owner or mineral rights leaseholder of the land surface into which the well is to be sunk. This fact reflects a market adjustment to risk by cutting the organizer of the venture and the other participants into the possible increase in land values (economic rent) should the wildcat prove successful.[45]

Not all exploratory wells are drilled on the basis just outlined. It is not uncommon for a large producing company or a specialized wildcat broker to put together an entire exploration program, and then sell some or all of it in shares to outside participants. The virtue of a large program is that it can be made "self-insurable;" that is, the prospect of enough successes to make the entire program pay can be made "certain" in the actuarial sense. A drilling program costing $10 million, in anticipation of finding minerals that would yield an average of $1 million in cash flow each year for a number of years is formally identical, from an economic point of view, to investing in a plant with similar costs and returns.[46]

Up to this point, the risk being discussed has in fact been what is often called "pure risk": multiple possible outcomes whose distribution characteristics (mean, variance, etc.) are known with certainty. However, "uncertainty"—highly imperfect information—about the nature of the true distribution of possible outcomes is an important element of the high-risk justification for favorable tax tretament of minerals. The important point to notice here is that information is an economic good: it is useful in the production process and costs money to obtain and utilize. In most cases, therefore, the market will assign information a price, and there is no need for government intervention unless something is wrong with that price.[47]

The entire process of exploring for and developing mineral deposits can be viewed as designed to produce and utilize information on the economic character of possible prospects. (Even "dry holes"—wells that fail to turn up economically viable reserves—yield information which can be utilized in planning further exploration and/or development.) This process typically extends over a long period of time, from a year on up, when viewed from the date of initial discovery of exploitable minerals to the beginning of extraction But far from being a defect of natural resource production necessitating a subsidy, as is sometimes argued,[48] this long period is a rational response to the basic economics of natural resources, one which is easily—and best—handled by the market mechanism.

The preceding argument should not be misconstrued. I do not intend to claim that mineral exploration is riskless and certain. The central point to be made is that, in view of the creativity and ingenuity with which operators in mineral industries have been able, through the market, to spread risks, and in view of the conventional economic nature of geological information, it is not at all clear that the risk and/or uncertainty in mineral exploration are any greater than in other forms of economic endeavor. Nor is it clear that such risk and uncer-

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[44] The following discussion of adaptations to risks in exploratory mineral ventures draws heavily on Grayson 1960, a highly readable as well as informative book.

[45] "If everyone concerned has perfect foreknowledge of the existence, size and properties of the oil pool . . ., the landowners could exact . . . [the] rent from the developing firm in the form of lease bonuses." But in the absence of perfect information, the landowners are willing to give up some of the potential rent to the developer in return for his drilling services. The expected portion of the economic rent can be viewed as one of the returns of risk-taking. (McKie and McDonald 1962, p. 108).

[46] This statement is actually weaker than it need be. It is not unlikely that the drilling program would be *less* risky than a single plant costing $10 million and designed to produce a narrow range of consumer goods. Nelson in *Federal Tax Policy* 1955, p. 470, makes a similar point.

[47] The market may lead to a less than optimal amount of information obtained and processed if the returns cannot be captured by the individual party who would make the outlay for it. But externality in return to information is by no means peculiar to the extractive industries. One solution is to have a government or quasi-govermental organization (such as a trade association) collect the information and distribute it to individual parties. Of course, the political problem of deciding which information to gather and how to finance the task remains.

[48] For example, in Paley 1952, p. 33.

tainty as apepar to exist in the mineral industries justify special tax favors for those industries.

Two final points about risk and present tax policy. First, the percentage depletion allowance enhances the return only on successful explorations, since it depends on realized extraction; hence it would relieve costs due to the dispersion of possible outcomes ("pure risk") only tangentially.[49] In contrast, the present general provisions for the corporate income tax provide for "loss offsets" to tax liability which go a considerable distance toward relieving the burdens of the left-hand tails of the outcomes distribution.[50]

Second, the degree of risk actually *observed* in an extractive industry at any point of time depends upon how far out on the "extensive margin" operations are being carried. The further out on this margin, the greater the proportion of less likely, more uncertain prospects that will be drilled. But earlier in our discussion of economic efficiency, we saw that the present tax assistance to mineral producers tends to push them farther out on the extensive margin. To the extent this tendency is realized, therefore, we have the anomaly that present natural resource tax policy actually increases the average risk observed. Logic would seem to forbid turning around and using "high risk" to justify a subsidy which contributes to it in the first place.

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We come now to "national security", the fourth group of arguments used to justify the present system of tax expenditures on the extractive industries. National security is a public policy goal which few would oppose, and for this reason any program which promotes it at reasonable cost is worthy of consideration. By the same token, national security is apt to be invoked by anyone and everyone seeking governmental sustenance for a pet program. The very real possibility of misuse of an important goal is sufficient reason for giving costly programs parading in the name of national security doubly careful consideration.

A recent, definitive study of national energy policy concluded that the "national security objective" has never been adequately formulated or studied in connection with general natural resource policy.[51] That this conclusion is justified so far as mineral industry arguments for tax assistance are concerned is soon obvious to anyone who dips into the literature seeking to justify our present tax treatment of minerals.[52] This literature in fact provides numerous examples of the "scare tactic" and "inflated rhetoric" groups of justifications for special tax treatment discussed earlier. Whereas by themselves such justifications are inane and even humorous, when they invoke national security they are no longer merely frivolous but downright dangerous.

Failing useful guidance from the industry sources, let us construct our own simple framework for assessing the national security policy problem as it pertains to the extractive industries. No one will dispute that natural resources are "essential" to national security. The real question for public policy, however, is how essential natural resources are in relation to all other forms of output. The only plausible answer to this question is that in general, natural resources are no more "essential" to the national security than metal goods, textiles, rubber, agriculture, and other major product groups. Note that in the age of "total war", even the consumer goods industries are highly "essential". No argument for special tax relief is to be found here.

The central economic concern in national security planning for any sector of the economy would seem to be the capacity to supply large quantities over an extended period without incurring damagingly heavy costs—a vague concept, to be sure, but one which at least provides a starting point for rational discussion. By this criterion, our present program of tax assistance to natural resources does not fare very well, since it is ineffectual in adding to productive capacity—i.e., in stimulating the holding of mineral reserves—and on top of it stimulates current output.

An often neglected aspect of the capacity criterion is the availability of substitutes. The ability of this nation to produce synthetic rubber during World War II is only the best known example of the key role substitutes can play in national

[49] *Tax Reform Studies* 1969, Part 3, pp. 429–430.

[50] Musgrave 1962, p. 206.

[51] Resources for the Future 1968, pp. 45, 143–144. However, Nelson in *Federal Tax Policy* 1955, is a good starting point.

[52] For a self-styled "unassailable" argument, which touches on the key points always raised by industry apologists, see Smith in *Federal Tax Policy* 1955, pp. 492–493.

security. Unfortunately for mineral industry apologists, the present set of tax expenditures on minerals flunks this test, too. To the extent tax subsidies on natural resources depress their prices below what they would be if the market had its way, the development of substitutes is impeded. Perhaps the most dramatic example of this effect at the moment is the lagging progress in developing oil shale and the hydrogenation of coal:[53] however, while petroleum is the largest beneficiary of federal tax largesse at present, this phenomenon is not confined to the petroleum industry.

To summarize the discussion of the national security objective, all available evidence (much of it cited in this paper) indicates that present federal tax policy towards natural resources largely fails to promote national security, and may even hinder the pursuit of a rational policy. Present tax provisions only weakly spur acquisition of mineral reserves, and work to stimulate current output—neither of which helps very much to create reserve capacity. Far cheaper, more effective alternatives are available; for example, government, "stockpiling" of developed but inactive mineral deposits,[54] or explicit appropriations directed to the creation *and holding* of new reserves of natural resources.

It is noteworthy that during 1969—a year remarkable for the intensity of public pressure to remove special tax (and other) privileges from the petroleum industry—the public relations strategy of petroleum interest groups has shifted from national security to the level of consumer product prices. The implication of the industry's Congressional testimony and of its mailings to stockholders and credit card holders is that the present special tax provisions have been "responsible" for keeping oil prices low, and that removing those provisions would "cost" consumers large sums because prices would rise substantially. Unfortunately, no convincing quantitative proof of these assertions has been forthcoming; in fact, there have been sizable price increases in 1969 *with* the present special provisions, giving rise (as Senator Proxmire and others have noted) to higher gross revenues and higher profits, *ergo* more generous depletion allowances. Moreover, the petroleum industry has failed to explain why its product prices should be manipulated through the tax system and not the prices of other "essential" products like milk and clothing. Nor has it bothered, of course, to point out that the consumers who benefit from lower prices are also taxpayers who bear greater tax burdens because petroleum incomes are so lightly taxed. (If the industry were truly serious about reducing prices to consumers, it would be asking for relaxation of oil import restrictions and the dismantling of the various state prorationing schemes—the exact opposite of their present stands on these questions.) The "low price" argument is therefore clearly seen to be just another case of industry scare tactics.

C. *Conclusions on the relation of current natural resource tax policy to economic efficiency*

The conclusions which emerge from the foregoing discussion of economic efficiency and our present tax treatment of the extractive industries are not encouraging, to say the least. This treatment, which taxes the form of tax credits does not achieve well any of the several aims supposedly set for it. Many of the benefits constitute little more than gifts to producers who are rewarded with federal funds for taking actions they would have taken without any federal reward. Furthermore, the undesirable side effects of present mineral tax policy are numerous.

Rep. Wilbur Mills, Chairman of the House Ways and Means Committee has aptly labelled tax expenditures through the revenue side of the budget "back door spending."[55] Such spending, as opposed to outright appropriations, has at least three defects, according to Mr. Mills: It is seldom reviewed by either the Executive Branch or the Congress; to determine whether it is necessary: accurate data on true costs and benefits of such spending are often difficult to obtain; and too frequently public moneys are wasted on firms which would have undertaken the intended activity without added stimulus.

One can only conclude that all of these defects plague our present back door spending program for the extractive industries. Only with these defects could

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[53] *Tax Reform Studies* 1969, Part 3, p. 418, 433. Other facets of national oil policy, such as the oil import quotas and state "allowables" prorationing, of course work in the other direction.

[54] *Ibid.*, p. 433.

[55] In a speech to the House, December 13, 1967 (*Congressional Record—House*, p. H16890, 1967).

such a wasteful program have remained in existence for so long. It is high time those defects were corrected, and the program itself abandoned.

IV. Administrative difficulties

Past evaluations of the special tax provisions for the extractive industries have focused mainly on the subjects of equity and economic efficiency. Insufficient attention has been paid to a number of serious problems that arise when we attempt to administer those provisions. These problems deserve scrutiny for several reasons. First, the very existence of continuing and growing administrative difficulties makes tax assistance an even less effective program for aiding the mineral industries than considerations of equity and efficiency would suggest. To be an effective tool of public policy, a subsidy mechanism should be fairly simple and direct in its operation. A system shot through with administrative uncertainties is unlikely to stimulate the desired busines responses.

Second, the legal and accounting costs involved in settling disputes, the heavy demands on the federal courts, the seemingly unending need for new administrative ruling and determinations, and the federal bureaucracy required to deal with these matters, all increase the social cost of our system of back door spending on the mineral industries.

Unfortunately these problems seem to be getting worse, not better; they are certainly far more serious now than they were when percentage depletion was first introduced in the 1920's.

The problems of administering our program of tax aid to natural resources concern mainly the percentage depletion deduction. They fal linto five major categories.

The first category involves the concept of an "economic interest", possession of which is a prerequisite to claiming a percentage depletion deduction. Much ink has been spilled in learned discussion of the term "economic interest". As things stand today, there are two separate requirements which must be satisfied if one is to have an "economic interest" in a mineral deposit. First, an interest in a mineral in place in the ground must have been acquired by investment, and, second, the taxpayer must look solely to the extraction and sale of the minerals to recoup that investment.

How these requirements apply in particular cases has been the subject of endless dispute and litigation. In fact, the precise scope of the term "economic interest" is probably less clear today than it was in 1933, when this concept was invented by the Supreme Court. For example, a recent study by a special subcommittee of the American Bar Association concluded that recent court decisions have "generated considerable confusion for both taxpayers and government" and have "contributed to the view of some that the economic interest concept is so confused that tax certainty cannot be achieved in all possible situations short of statutory amendment." [56] That same study also concluded, however, that agreement on acceptable restatement of economic interest principles for incorporation in legislation was so unlikely that the only real hope for answers lay in continued resort to the courts.[57]

The second category of problems involves the appropriate rate of depletion for a particular mineral product. The Internal Revenue Code prescribes rates for dozens of minerals, but not all minerals fit easily within these statutory categories. Moreover, difficult problems of geological identification are often presented by mineral materials which blend into one another, or which consist of mixtures of several different minerals. Expert testimony is usually needed to resolve these problems satisfactorily. As the technology of the minerals industries changes, new minerals come into use, and new depletion rate classification problems arise.

Chronic depletion rate disputes raise serious questions about the rationale for the various rates of depletion applied to particular minerals. These disputes are particularly acute in connection with minerals which are sources of energy. Included in this group are petroleum and natural gas, which are depletable at a rate of 27½ percent; uranium, with a 23 percent depletion rate; oil shale and tar sand. which appear to be entitled to 15 percent depletion; and coal which is

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[56] Report on Proposed Revision of General Counsel's Memorandum 22730, Subcommittee on Natural Resources, American Bar Association, published in *The Tax Lawyer*, 22:2 (Winter 1969), p. 263.
[57] *Ibid.*, p. 273.

depleted at a rate of 10 percent. It is hard to justify this variation in rates, because a kilowatt of electric power or a B.T.U. produced from coal will light as effectively and heat as well as a kilowatt or B.T.U. produced from uranium or oil. The likely explanation is that these varying rates are simply the accidental result of the political climate which surrounded the grant of percentage depletion to these minerals. That is simply another way of saying that there is no rational economic justification for the present rate structure.

The third problem area concerns the "cut-off point", that is the amount of processing which can be treated as mining or extraction and thus included in the depletion base. Percentage depletion is computed by multiplying the selling price for a particular mineral product by a percentage which, generally, is set forth in the Internal Revenue Code. For example, in the case of natural gas, percentage depletion is computed by multiplying the selling price of raw gas by 27½ percent. The result of this computation is the taxpayer's depletion deduction. But what is "raw gas"? Is it gas in the form in which it emerges from the mouth of the well, without any processing at all? Or is it gas which has been desulphurized, dehydrated, and compressed for introduction into pipelines? A customer might pay only 10¢ or 12¢ for m.c.f. for raw gas at the wellhead, but might pay twice as much for processed gas which has been brought to pipeline quality. Consequently, a gas producer's percentage depletion deduction can be doubled by computing depletion in terms of the value of processed gas, rather than in terms of gas at the well mouth. Similarly, if pipeline transportation of gas can be treated as part of the extractive process, so that depletion is computed in terms of the selling price of gas at the far end of a pipeline, the depletion deduction can be trebled or quadrupled. Cut-off point problems of this sort are very common, and are extremely difficult to resolve because there are few rational economic principles which can be applied to these questions.

The fourth problem category concerns the unit price to be used at a given cut-off point to compute the gross income on which percentage depletion deductions are based. Sometimes a wide range of prices are charged to different customers for the same mineral product. If the highest of these prices is used when computing percentage depletion with respect to that portion of the output which a producer retains for his own use, a producer can sometimes as much as double his depletion deduction. Even small price increases can be highly beneficial. For example, if an oil company produces most of its own crude, and buys the rest, the firm can increase its depletion deduction substantially by simply raising the price which it pays for the purchased crude because that is generally the price which is used to compute percentage depletion for the firm's own production. Paying more for crude can therefore result in a net after-tax saving!

But suppose there are no market prices available for use in making comparisons—what then? This is a very common situation. For example, in the copper industry, there are few open market sales of copper concentrate (that industry's depletable product) and some other method of establishing prices for computing gross income must therefore be adopted. Similarly, American companies produce petroleum in many areas of the world such as the Persian Gulf, in which there are no reliable market prices for crude petroleum. And, in a number of cases, Congress has established the "cut-off point" for depletion purposes at a point at which nothing is sold; an example is the kiln feed cut-off point for portland cement. Obviously, some substitute valuation formula must be used in these cases, but what formula? And how, in detail, should the formula work? All these problems remain in dispute, because it is difficult to substitute a formula for a market price.

The fifth problem area is the computation of the statutory fifty percent net income limitation on percentage depletion deductions. It is simple enough to state that the percentage depletion deduction shall not exceed half the net income from a mineral property. But what is "net income" for this purpose? Do normal accounting rules apply in computing "net income"? Does "net income" for depletion purposes mean the same thing as "net income" for general tax purposes? What costs are to be taken into account when computing net income? How are overhead and other indirect costs to be allocated between mining and manufacturing when computing this limitation? All of these questions are being actively disputed today, even though the fifty percent net income limitation has been part of the law for more than forty years.

V. The special tax provisions for the extractive industries and the general capital gains option

It has been pointed out that the beneficial effects of repealing the present special tax provisions for natural resources would be limited by the use of the capital gains option as an alternative escape route from federal taxation.[58] This argument seems to be correct: The developer of a deposit would sell his successful find, being taxed at the favorable gains rate, and the purchaser of the deposit would use the high sales price as the basis for cost depletion. While the value of the deposit would tend to be lower than if percentage depletion were still available, the prospective buyer would be willing to pay a higher price because he can use the purchase price for cost depletion deductions.[59]

This interrelationship has been used by both sides in the debate over whether to change the present special tax treatment of natural resources. My own conclusion is that it does not alter the need for rescinding that special treatment, for two reasons: (1) the capital gains option is a less than complete substitute for the percentage depletion allowance; and (2) even if it were a perfect substitute, getting rid of the percentage depletion allowance would clean up the administrative mess documented in the preceding section, thereby clearing the air for possible consideration of the capital gains option as a tool of public policy. Each of these reasons is examined in turn.

It is sometimes alleged that percentage depletion is merely a "substitute" for the capital gains option, designed to permit a mineral producer to receive "fair" tax treatment without being "forced" to sell his entire property.[60] This superficially plausible argument overlooks the fact that adding the depletion allowance to the capital gains option enhanced the tax benefits from the latter: capital values would tend to rise with percentage depletion, by making the ownership of a deposit for production purposes more profitable. Conversely, removal of percentage depletion would tend to depress capital values. The capital gains-cost depletion mechanism outlined earlier provides only a floor, not a complete compensation, for capital values, since electing percentage depletion generally results in far greater tax savings than cost depletion. Thus there would very likely be some net cutback in tax spending on the mineral industries if percentage depletion were removed, even if the capital gains option were still available. A small additional piece of circumstantial evidence on this score is the willingness of the mineral industries to spend considerable time and money persuading the Congress and the Executive Branch that it still needs and deserves percentage depletion.

The second reason for preferring to rescind our present special tax provisions for minerals even if the capital gains option would reduce the impact, is the social saving in reduced administrative costs. Not only would lawyers, accountants, engineers and economists, in both industry and government, be freed for productive work, but the court system would be relieved of a large burden and at least a small reduction in the federal bureaucracy could be effected.

In short, the possibility of substituting the capital gains for the percentage depletion route to tax benefits is a real one, but on balance it does not constitute an acceptable argument for postponing action on the latter provisions.

VI. The proposal for a "minimum tax" system

Proposals have at various times been mooted for a "minimum tax" system that would reduce the inequities and wastes of the present income tax system.[61] On the face of it, a minimum tax would in fact serve to blunt the incentives to seek tax relief, including the special tax provisions for natural resources, and thereby weaken the inequities and waste. However, serious examination indicates that a minimum tax system would be at best an imperfect substitute for direct action on the root causes of the current troubles; as I have indicated earlier, one of these causes is the special set of tax benefits for mineral producers.

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[58] For example, S. L. McDonald, *Federal Tax Treatment of Income from Oil and Gas* (Washington: The Brookings Institution, 1963), p. 5.

[59] Smith in *Federal Tax Policy* 1955, p. 487.

[60] For example, Stanley in *Federal Tax Policy* 1955, p. 476. He cites a court opinion, West v. Commissioner of Internal Revenue 150 F. 2nd 723, to the effect that depletion "may be regarded as a substitute for the capital gains allowance . . ."

[61] Most recently, in *Tax Reform Studies*, especially Part 2, pp. 173ff., and in the House Ways and Means Committee's recommendation of July 23, 1969 (*New York Times*, July 24, 1969, p. 1, columns 2–3).

First, enactment of a minimum tax as currently proposed would in effect create a new income tax system parallel to the original one enacted in 1913. This is a major defect in the proposal, since it would only compound the already considerable administrative difficulties of the present system. Instead of one statute, with all its problems, we would have two, and the resulting extra problems, including co-ordination of the two statutes, could well make present administrative difficulties seem like child's play.

The second defect of a minimum tax system is its doubtful effectiveness. For instance, why should we suppose that the mineral producers who successfully escape taxation under the present income tax laws would be any less successful in escaping the minimum rate? If, on the one hand, the minimum tax is levied at a rate which produces a sizeable amount of revenue, we can be sure that mineral producers will be anxious to avoid payment of that tax; their success in avoiding existing income taxes gives us no basis for believing that they would be any less persuasive in avoiding the minimum tax. On the other hand, if the minimum tax is levied at a rate which is so low that it makes no difference to mineral producers whether they pay this tax, then a minimum tax system would be little more than a cruel joke, designed to make wage earners think that others are bearing a fair share of the nation's tax burden. In short, if the minimum tax is to be a real tax, then it will present the same political problems as does the existing income tax. And if the minimum tax is not intended as a real tax, there seems to be no justification for enacting it.

Consequently, the minimum tax proposals are not really a satisfactory substitute for genuine tax reform. In fact, the cause of tax reform will probably be better served by rejecting the minimum tax proposal in favor of a more determined effort to reform the existing tax system. The extremely limited nature of the Treasury's minimum tax proposals lends support to this argument. For example, under the Treasury's proposal, some intangible drilling costs would continue to be expensed, as under existing law. Similarly, exploration and development costs would continue to be expensed, and foreign tax credit abuses would remain largely untouched. Furthermore, the type of minimum tax proposed by the Treasury would not apply to corporations. Consequently, the only mineral tax abuse importantly affected by the proposed minimum tax would be the deduction of percentage depletion in excess of cost depletion in the case of individuals.

Accordingly, the Treasury's minimum tax proposals would fail to do anything at all about the bulk of the serious revenue loss which occurs as a result of our special tax provisions for the minerals industries. A toothless proposal of this sort is not a proper substitute for tax reform.

VII. Summary and conclusions

In this paper I have attempted to evaluate the effectiveness of our special tax policy toward the extractive industries, which consists of the percentage depletion allowance and various provisions for current expensing of exploration and development outlays. My conclusion is that there is little or no justification for retaining this special tax policy. On the contrary by standards of sound public policy there are a number of good reasons for scrapping this policy.

First, the present special tax provisions for minerals lead to serious inequities both between similarly situated taxpayers and between taxpayers at different levels of income. Such inequities may gravely undermine public confidence in our federal tax system if they are permitted to continue.

Second, those special provisions constitute a large waste of federal tax monies. They only weakly accomplish what they are supposed to accomplish, and hand out generous rewards where they are neither justified nor necessary. These monies could be spent much more productively at the present time (and for the foreseeable future.)

Third, present special tax treatment of minerals, especially the percentage depletion allowance, gives rise to a tangle of costly, unproductive and frustrating administrative difficulties. Not the least benefit of removing special mineral tax treatment would be to clean up this administrative mess.

It is true that the general capital gains option would provide an alternative route for escaping taxes on mineral incomes, and hence would dilute the benefits that would be realized if we closed the existing escape route. But this fact does not reduce the desirability of rescinding what by all the evidence is a poor public policy program. The dilution of effects would be only partial. What is more, having only the capital gains option to worry about, for other industries as well as the extractive sector, would greatly clarify and simplify the public policy problem of how much aid, if any, should be given to the extractive industries. At the same time, we would get rid of the serious difficulties of administering the present set of special tax aids.

Some form of minimum tax system could in theory help relieve the inequities and waste associated with current natural resource tax policy. But it would be only a very imperfect substitute for direct action aimed at the real underlying causes of the inequities and waste. One of those causes is the special tax provisions for the mineral industries.

The time is ripe for serious consideration of improving the federal tax system. It is my firm conviction that removing the mineral percentage depletion allowance and the various provisions permitting the current expensing of exploration and development costs represents a golden opportunity for improvement. The recommendations of the House Ways and Means Committee, in July 1969, to reduce percentage depletion rates and restrict a number of devices for widening the tax loopholes on natural resource incomes, are a step in the right direction. But in my opinion the Committee stopped short of the full solution. Moreover, they did nothing about the current-expensing provisions for exploration and development costs. If any change is worthwhile—and I believe it is—the logic behind it requires basic, i.e., complete change if tax reform is to be meaningful.

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Comments on the Mid-Continent Oil and Gas Association's Critique of the CONSAD Report

(Arthur W. Wright, University of Massachusetts)

The Mid-Continent Oil and Gas Association has recently circulated a critique of the CONSAD report.[1] This critique runs to 41 pages and required a large group of analysts—a "task force," as *The Oil Daily* put it[2]—to prepare. Because the Mid-Continent critique of the CONSAD report raises several general issues which pertain to my earlier remarks before the Ways and Means Committee—in testimony (March 21, 1969), in a supporting paper, and in supplementary responses to Committee members' questions—it seems appropriate for me to make a few brief comments regarding that critique. At a later date, perhaps, others can invest the time and resources which would be needed to make a point by point evaluation of the Mid-Continent presentation.

Shift of emphasis in petroleum industry arguments

Up to now, the main theme of industry arguments for retaining percentage depletion and intangibles expensing has been the claim that extra reserves are created and held against a national emergency as a result of these tax provisions.[3] In the Mid-Continent critique, however, reserves reduced to a mere "technological" relationship to production. If this is the case (which is doubtful, given the changes in reserve-production ratios which Mid-Continent itself points out), it is difficult to argue at the same time that special tax provisions will build up reserves relative to production, and thus insure sufficient reserves for national security. In short, the Mid-Continent critique of CONSAD actually has the effect of denying the traditional national defense argument for the special tax provisions enjoyed by the petroleum industry. Instead, Mid-Continent argues that the rate of current output and its cost are the main variables affected by the special tax provisions for petroleum. This is a highly significant change of emphasis.

I personally welcome the shift of emphasis, since the new argument is more amenable to thorough economic analysis. What is needed is a study which looks at both output and reserves[4] in relation not only to tax policy but also to oil imports, state production restrictions, and other petroleum policies.[5] In such a study, the public policy problem could be formulated properly, with national security one, but only one, of the possible desirable goals in deciding on national policy toward the petroleum industry. As I will indicate in greater detail below, the petroleum industry should do its part by sponsoring an independent study of the costs and benefits of present public policies towards petroleum.

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[1] "Analysis and Comment relating to the CONSAD Report on the Influence of U.S. Petroleum Taxation on the Level of Reserves," dated April 25, 1969; the courtesy of the Mid-Continent Oil and Gas Association in furnishing me a copy of this criticique is gratefully acknowledged. The CONSAD report appeared as Part 4 of the House Ways and Means Committee's *Tax Reform Studies and Proposals, U.S. Treasury Department* (Washington, 1969).

[2] April 28, 1969, p. 1.

[3] Indeed, the Treasury initially commissioned the CONSAD study to test this claim.

[4] Surely the relationship of reserves to output, in connection with price movements and other economic variables, is more complex and more interesting than the simplistic formula on page 9 of Mid-Continent's criticique.

[5] Shifting the emphasis to output and costs leads us directly to the import and production restriction issues, which, if we can believe the overwhelming preponderance of recent testimony before the Senate Subcommittee on Antitrust and Monopoly, make special petroleum tax provisions pale in quantitative significance.

"Perfectionist" Criticisms of the CONSAD Report

The Mid-Continent task force's critique of the CONSAD report raises a number of important issues. Unfortunately, the thrust of their argument is lost, because the discussion of these important issues is buried among many trivial issues and needless details. So apparently eager were the authors of the critique to discredit the CONSAD report that they threw in every conceivable objection.

Another serious problem with Mid-Continent's critique is that its attack on CONSAD's statistical methodology is perfectionist. If we took to heart every one of Mid-Continent's criticisms, the economics profession should close up shop and retreat to its ivory tower to work on pure theory. However, tax policy, like day-to-day business policy, must depend on decisions taken now, on the basis of the best data and analysis available, rather than waiting for absolute theoretical perfection.

Quantitative economic analysis, like business decisions, is plagued by problems of reconciling ideal methodology with available data. The reconciliations almost always involve choices which are "costly" relative to the ideal situation. CONSAD made certain choices as a result of constraints imposed by the limited availability of data; these choices, and some idea of the "cost" involved, were made fairly clear in their report to the Treasury. One choice for which Mid-Continent's critique severely attacks CONSAD—the use of aggregative data rather than individual oil-district data such as Erickson used in his recent study of new crude oil discoveries[6]—was in fact forced upon CONSAD by limitations of data. Instead of carping that the CONSAD Report is not absolutely perfect, Mid-Continent should undertake to assist in furnishing the data which will assist in eliminating the Report's imperfections.

Who has the burden of proof?

The last sentence brings me to what I consider the most important point: In its critique of the CONSAD report, the Mid-Continent Oil and Gas Association, a major petroleum industry spokesman, was able to assemble a task force of economists to write a lengthy detailed critique of the CONSAD report in a mere month and a half. This task force was clearly quite capable of applying economic analysis to federal tax treatment of the petroleum industry. It also included people versed in the statistical and econometric methods necessary to pose and answer public questions in a meaningful way. It is to be regretted that this task force did not attempt to set forth a reasoned justification of the petroleum industry's traditional arguments in favor of percentage depletion and other special tax benefits enjoyed by the industry. Instead, the task force was content merely to react to the CONSAD report, without advancing any positive arguments of its own.[7]

If the Mid-Continent Oil and Gas Association does not like the CONSAD report—a reasonable inference from their critique—why do they not set this task force or a similar group to work on a study which seeks answers to the tax policy questions posed in the CONSAD report and in the Association's critique of that report? Sponsorship by the Association of such a study would be a responsible reply to the critique that the industry does not collect and disseminate adequate data for use in investigating important public policy questions in which the industry has a big stake. Special tax treatment of the magnitude currently enjoyed by the petroleum industry certainly requires justification; it seems only fair that the principal beneficiary of such treatment should pull its own weight in providing the justification.[8] The petroleum industry cur-

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[6] Edward Erickson, *Economic Incentives, Industrial Structure and the Supply of Crude Oil Discoveries in the U.S.*, 1946–1958/59 (unpublished Ph.D. dissertation, Vanderbilt University, 1968).

[7] A minor exception to this statement is the discussion of the "McDonald debate" on "tax neutrality," which is appended to the critique of the CONSAD report. However, as I pointed out in the paper supporting my testimony before the House Ways and Means Committee on March 21, 1969, economists working on tax policy—Professor McDonald included—generally agree that "tax neutrality" is a dubious public policy goal. Moreover, many people now argue that it is virtually impossible to define "tax neutrality," taking into account differential elasticities of demand for output and other important considerations, for purposes of empirical testing.

[8] The industry could at least assist the federal government in collecting and processing the necessary data, by permitting detailed inquiries and co-operating in data reporting programs.

rently spends large sums on public relations to publicize what are, at present, unsupported arguments for continuing the present special tax treatment of petroleum. Some of these outlays could and should be diverted to ascertaining whether or not there is any rational support for these arguments, e.g., through a study such as the one proposed above.

In short, in assessing the relative merits of present federal tax policy toward the petroleum industry, a major share of the "burden of proof" falls on the industry itself. That burden is not being borne simply by criticizing the work of others, as is done in the Mid-Continent critique of the CONSAD report.

Senator McCarthy. The hearing will resume at 9:30 tomorrow.

(Whereupon, at 3:45 p.m., a recess was taken until 9:30 a.m. Thursday, October 2, 1969.)

TAX REFORM ACT OF 1969

THURSDAY, OCTOBER 2, 1969

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 9:30 a.m. in room 2221, New Senate Office Building, Senator Herman H. Talmadge presiding.

Present: Senators Long (chairman), Talmadge, McCarthy, Gore, Byrd, Jr. of Virginia, Ribicoff, Williams of Delaware, Bennett, Curtis, Miller, Jordan of Idaho, Fannin, and Hansen.

Senator TALMADGE. The committee will come to order.

The first witness is the distinguished Senator from Oklahoma, the Honorable Henry Bellmon.

We are delighted to have you with us, Senator. You may proceed as you see fit.

STATEMENT OF HON. HENRY BELLMON, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator BELLMON. Thank you, Senator Talmadge. I will not read the whole statement.

Senator TALMADGE. At this point the full statement will be inserted in the record and you may proceed to summarize your statement orally or as you see fit, sir.

(Hon. Henry Bellmon's prepared statement follows:)

STATEMENT OF HON. HENRY BELLMON

Mr. Chairman, Members of the Finance Committee, I appreciate the opportunity to appear to testify regarding HR 13270 and wish to thank you for the courtesy which you have extended to me.

In the short time available, I have attempted to review HR 13270, particularly as to four aspects of the legislation. These are the provisions of the bill that affect the agricultural and petroleum industries, those provisions that relate to municipal bonds, the personal exemption allowed individual taxpayers, and certain administrative procedures of the Internal Revenue Service. I have prepared a statement which I will not read. I ask unanimous consent that it be included in the Record, and I will limit my oral testimony to a brief summary of this statement.

I believe that the main purpose of our tax system should be to raise revenue. During the period since the 1930's, the idea of using our revenue-raising laws to accomplish certain social aims has complicated and caused great confusion in the administration of these laws.

With the passage of a vast quantity of social legislation in other fields, with the increased socially oriented activities of the United States Supreme Court, and with the creation of many additional federal programs to deal with social problems, it occurs to me that any tax reform legislation passed by the present Congress might well take note of the fact that the need for using our tax system for social purposes may no longer require the same high priority.

If this concept can be adopted, the law can be vastly simplified. It can be much more easily understood and followed by individual taxpayers, and it can be much more effectively enforced by those who are charged with its administration.

In a recent conversation with an official at the Internal Revenue Service, I was amazed when he told me that, "if the taxpayers of this country ever discover that the Internal Revenue Service operates on 90% bluff, the entire system will collapse." He further went on to tell me that when he first joined the Service in the 1940's, his reference manuals occupied thirteen inches of shelf space. At the present time, he must rely upon books of instructions and interpretations that make up a total of thirty-three feet of shelf space in his office. Plainly, simplifying of our tax laws should have a high priority. Much of the statement I have prepared for the Record is aimed in this direction.

There seems to be danger, that in its efforts to administer the present complex and confusing law, the Internal Revenue Service is resorting to tactics which frequently seem to border on coercion. Many innocent taxpayers who are accused by the International Revenue Service of irregularities, find it less costly to pay the additional taxes and penalty than to go to court and prove their innonce. Therefore, I would recommend that a tax reform law include a provision which would allow a taxpayer who goes to court and successfully proves his innocence to recover the costs of such litigation from the Federal Government.

When the present Internal Revenue Code was first put into effect and the $600 personal exemption was established, the purchasing power of our currency was far in excess of what it is today. The present $600 exemption is totally inadequate to meet the living costs of even the most modest American citizen. It is well below the "poverty level" set forth in many federal programs.

Therefore, out of a sense of equity, I believe Congress should immediately adjust the personal income tax exemption upward. If the total adjustment cannot be made in one year, it should be made in stages that will not unduly upset the Nation's economy, but that will assure the American taxpayer that the equity will be established within a reasonable time.

H.R. 13270 contains provisions which strike heavily at the two industries which have done far more than their share in keeping this Nation strong, in holding the line against inflation, and in making us the best-fed people on the face of the earth. I refer to the agricultural, mineral and energy industries which are of such vital importance to the strength, security, and prosperity of this Nation and which are of particular importance to my own State of Oklahoma.

The fact is that agriculture, since World War II and even before, has been in serious financial trouble. As one who has spent most of his adult life in agriculture, I can assure you that except in unusual circumstances, most food and fiber producers have been selling their products at or near the costs of production.

As a result, agricultural operations have not produced the financial resources farmers and ranchers need to improve and conserve our soil, drain or clear new land for production, or develop improved livestock, or new plant varieties. These developments are needed to keep our agricultural production ahead of the demands of our growing domestic population and the food requirements of our customers and friends in other nations. Therefore, agriculture must attract outside capital if it is to continue meeting the needs of our Nation.

Many provisions of HR 13270 will have the effect of driving outside capital away from agriculture and thereby freezing our agricultural production capacity into its present pattern.

It is ironic that such changes would be proposed at this time when there is growing concern for world hunger and a greater than ever need for maximizing the agricultral productive capability of this country for the future. Unless these agricultural development efforts continue year after year, the improvements will not be available as they are needed. As a result, our abundance may disappear and our food prices may be forced upward, sharply, as our population grows. In the Nation's interests, the Congress cannot afford to adopt changes in our tax laws which will drive outside capital away from agriculture.

Much of the same arguments can be made for the mineral and energy industries. I have before me a statement made by Mr. Andrew Fletcher, Honorary Chairman of the St. Joseph Lead Company, when he appeared before the Subcommittee on Minerals, Materials, and Fuels of the Senate Interior Committee. I would like to quote briefly from his remarks.

"The United States is a prodigious consumer of minerals and fuels. The startling truth is that we have consumed more of these resoruces in the last 30 years than the entire peoples of the world in all previous history. In the single decade from 1965 to 1975, it is estimated that our mineral consumption will have climbed 40 percent. Today, the worldwide per capita consumption of iron and copper is about one sixth that of the U.S., and for lead it's about one eighth. Looking further into the future, we can see that not only will our own growing appetite continue, but other nations and particularly underdeveloped nations will increase their demand at an even more rapid rate than ours.

"It is becoming somewhat trite, I know, to cite expectations about the year 2000. But it is also sorbering to realize that the millenium is about as far ahead of us as the beginning of World War II is behind us. With this in mind, let's look at the statistics. Comparing the figures for 1965 and estimates for the year 2000, based on Bureau of Mines projections, we find:

U.S. zinc consumption will increase by almost 375 percent; the worldwide total by about the same.

U.S. lead consumption will increase by over 200 percent; the worldwide total by more than 250 percent.

U.S. iron consumption will increase by nearly 175 percent; the worldwide total by more than twice that much.

U.S. coal consumption will increase by over 250 percent; the worldwide total by over 575 percent.

U.S. copper consumption will increase by over 200 percent; the worldwide total by nearly 375 percent.

"It will be no easy task to meet these soaring demands, and it is notoriously difficult to estimate the resources we will have at our command. This is not only because we cannot foresee what geological discoveries may lie ahead. It is also because the exploitation of orebodies depends on so many factors: location, quality, technology, marketability, etc. Nevertheless, a study by Resources for the Future, Inc. has concluded that over the next three decades, the U.S. will be largely dependent on imports for such vital metals as manganese, chromium, nickel, and tungsten. More ominously, it believes that total world demand will begin to outstrip the known mining potential of copper, lead and zinc in all parts of the globe.

"Given this situation, there are those who argue that the U.S. should sharply curtail its domestic mining production, relying on imports for as long as possible and husbanding its own resources. In our judgment, this would be extraordinarily shortsighted.

"First, it is fatuous to believe that good foreign relations could survive this sort of behavior, with us carting home foreign treasure while carefully hoarding our own. This would become increasingly impossible as the rest of the world experienced a constant narrowing between supply and its own growing demand.

"Second, it would make us dangerously reliant on our present stockpiles or would call for a vast increase in those stockpiles. Moreover, once we allow mines and machinery and men to fall into disuse, it can take a long time—in the case of a national security emergency, a perilously long time—to restore them to productivity.

"Third, this is simply not a sound way to increase our command of mineral resources. Essentially there are only two ways to do that: either by exploration that leads to the discovery of new resources, or by developing the technologies that will permit more effective and economic exploitation of the ones we already know about.

"Exploration is no longer a matter of a lonely prospector with a pick and a mule. Today it is often a search for deeply buried deposits, requiring aerial photography; geochemical, aeromagnetic, electromagnetic, and ground magnetometer surveys; induced polarization; gravity surveys; and eventually diamond drilling or trenching. It is an expensive, arduous and frightfully risky enterprise. Even when an economically viable discovery is made, there can ensue a long period of huge capital expenditures before the minerals can begin to flow to the marketplace. For example, it will be in the mid-1970s, after a decade of development and costs of about $200 million, before American Metal Climax, Inc., will bring its new molybdenum mine in Colorado into production.

"Besides new discovery, we can expect to increase our available resources through improved exploitation. For example, at the turn of the century the grade of copper mined in the U.S. was around five percent. The profitable mining of lower-grade ore has become possible only because of immense investments of capital and ingenuity. There may be unbounded riches in what we now consider dross, if we can but find a way to win its value."

As far as future needs of petroleum are concerned, Secretary of Interior Udall probably summed up the situation best in an address before the National Petroleum Council in March of 1966 when he said:

"In the case of oil, if domestic sources continue to supply approximately the same relative proportion of our total demand for liquid hydrocarbons as they now do and if we elect to hold to the historic reserve-to-production ratio at 12:1, we will have to add 83 billion barrels to our proved reserves between now and 1980. This begins with a requirement of 4.7 billion barrels for the year 1966, and ends with a need for 6.9 billion barrels for the year 1980, with a yearly average for the period of 5½ billion barrels. This will not be easy. In only one year—1951—has the industry been able to record a gross addition of as much as 4½ billion barrels of liquid hydrocarbons to its proved reserves. Of more significance, the average of the yearly additions since 1955 has been 3.3 billion barrels.

"For gas, under the same basic assumptions and choosing to maintain a reserve-to-production ratio of 18:1, we shall need to add 450 trillion cubic feet to our proved reserves. This is an average of 30 trillion cubic feet a year. At no time in its history has the petroleum industry ever added as much as 25 trillion cubic feet to its reserves of gas in any one year. The average since 1955 has been 20 trillion. The meannig of these figures becomes even more clear if we compare our recent past experience with a comparable period of time in the immediate future.

". . . My point is simply that there is enough evidence at hand now to suggest strongly the need for us to consider more carefully than we have so far done, the question of how these enormous future demands for petroleum energy will be supplied."

Secretary Udall further stated to the National Petroleum Council in July 1968:

"The implications of this imbalance are for a gradual deterioration in the nation's capabilities to supply itself with crude oil. No precipitate, near-term crisis is in prospect, and the deficits could go on accumulating for several years. But it is clear that sooner or later the account must be balanced; no industry can go on indefinitely shortening its stocks in the face of a steadily rising demand for its products."

As is well known, my own State of Oklahoma has made a generous contribution to the energy needs of this nation over the years and our economy has come to depend heavily upon the oil and gas industries. The distinguished Chief Executive of the State of Oklahoma, Governor Dewey F. Bartlett, has appeared before the Committee and introduced compelling testimony relating to the critical needs of the oil and gas industry, and I do not propose to take the Committee's time to reiterate his position. I would like to emphasize and associate myself with his remarks.

These proposed changes in the tax provisions applicable to the oil industry will, without doubt, reduce the industry's incentive and ability to explore and drill. A recent study made by the Bureau for Business and Economic Research at the University of Oklahoma indicates that during a recent two-year period, independent oil producers drilled 86.5% of the exploratory wells and 20% of the development wells completed in the State of Oklahoma. In terms of the risk capital employed, the survey showed that 70% of the capital employed by independent operators is obtained from outside investors who are not connected in any other way with the independents' oil operations. Thus, it is clear that the independent oil producer in the State of Oklahoma relies heavily on outside investment funds as a source of capital to supplement his own funds obtained through capital recovery. Anything that will adversely affect the value of the ventures considered by the oil operator will also adversely affect the ability of the operator to attract the capital needed to continue drilling for new oil. If this results in a reduction in the activities of the independent oil operators as a group, it will have an adverse impact on the economy within which he operates.

The degree to which changes in tax legislation will affect the economy of the State depends upon the changes themselves. If the current write-off of intangible drilling costs is restricted and the proposed reduction in the depletion allowance to 20% is carried out, the survey to which I referred indicates that the drilling operations of independent oil producers in Oklahoma might be reduced by as much as 45%.

I have concentrated on the provisions in the House Bill and the Treasury proposals which affect domestic oil operations, particularly those of the independents. With respect to the foreign area I certainly support the Treasury in urging that Section 501, which would eliminate depletion on foreign oil and gas production, be deleted.

In considering the Tax Reform Bill of 1969, I feel that the key point, as it relates to the mineral, fuel, and agricultural industries is whether or not this Nation wishes to maintain a strong position of self-sufficiency in these vital areas. If it is the determination of the Congress that we want our Nation to become dependent upon imported minerals, fuel, and food then there could be justification for some changes proposed by HR 13270. If, on the other hand, we desire our Nation to be well fed with a reserve to be shared with other nations, if we desire a dependable low-cost source of energy from domestic sources for the citizens of our urban centers, and if we desire to have available on this continent the sources of the minerals which are vital to our industrial society, then there is need to attract capital into the development and operation of these economically hazardous occupations. Present tax laws provide such incentives. They must be retained and strengthened.

I do not wish to offer myself as an expert on tax matters. I recognize that many of the distinguished members of this committee have devoted much of their careers in government to study our tax matters, and that in addition, they have the counsel of highly qualified members of congressional staffs and governmental departments. However, I would like to suggest one possibility, so far as helping this Nation retain a strong supply position in minerals and fuels. As many of you know, I am a land owner, and if I sell a portion of my land, our present law allows me to treat the income as the sale of a capital asset and to pay taxes under the terms of our capital gains law.

On the other hand, if the owner of an ore body sells a quantity of the ore, he must show the income from this source as current income and pay tax after deducting a certain amount for "depletion allowance."

Over the years the depletion allowance, particularly as related to the petroleum industry, has come under sharp and in many cases totally unjustified attacks. As has been stated here, these depletion allowances have not been excessive since reserves of both minerals and energy sources have not kept up with our growing needs. Additional incentives are needed. I believe one way they could be provided would be for the Congress to pass legislation providing that the sale of mineral, or petroleum production be treated as the sale of a capital asset and taxed under the terms of our present capital gains laws. I would suggest that the depletion allowance be left at the present level and that the above approach be allowed as an option.

As a former Governor of the State of Oklahoma, I am fully aware of the growing needs of state and local governments, and I know from first-hand experience how many of these needs for additional services and facilities are met with funds made available by the sale of tax-exempt municipal bonds. Our own State of Oklahoma and its many sub-divisions could not come close to meeting our needs for hospitals, sewers, water systems, highways, airports, educational facilities, and many other necessary governmental services without the frequent sale of municipal bonds. Such sales would become virtually impossible under the provisions of HR 13270, and I would like to add my voice to the others you have heard opposing these changes.

As I said in the beginning of my statement, I strongly favor the passage of "tax reform legislation." There is great need for such legislation and a great impatience among the citizens of this country for more equitable and less complex tax law.

Senator BELLMON. I want to begin by saying that along with many others I am very much in favor of tax reform. I believe there is a considerable demand across the country that we do undertake to reform our taxes which have become entirely too complex and too difficult to understand, not only for the people who pay them but for the people who have to prepare the returns and those who administer the law, but I believe we should take note of the fact that the main reason for having a tax system is to raise revenue.

It seems that over the years we have let a lot of social concepts get into our tax system, and since we have been able to pass a great deal of social legislation in recent years, I believe it would be wise to review some of the social concepts of our tax law to see whether or not these are still so necessary.

If we can agree to accomplish our social objectives in other ways then certainly we can simplify our tax laws and make them much more easily understood and less difficult to administer.

I had a recent conservation with an administrative officer of the Internal Revenue Service and he finally let his hair down and told me that if the taxpayers of this country ever discover that the Internal Revenue Service operates 90 percent on bluff, that the whole system is going to come crashing down.

He went on to show me that when he first became associated with the Internal Revenue Service that his whole shelf reference manuals had occupied only 13 inches on his bookshelf at that time when I was visiting with him it took 33 feet of shelf space just to hold the manuals that he had to use in administering the law.

So it seems to me that it is time we tried very intently to simplify the law and make it so that it is not so difficult for those who administer and those who pay the taxes.

Also I would like to comment on the fact that it seems that in the present situation, our law is so difficult, so complex, so confusing, and so hard to administer that the Internal Revenue Service sometimes resorts to tactics that seem to border on coercion.

There are a lot of people that are charged with not paying the taxes due who find it less expensive and less troublesome to go ahead and pay the assessment than go to court and prove their innocence.

I would like to see the law changed so that when a taxpayer is accused of a tax irregularity and chooses to go to court and prove his innocence that if he succeeds in winning his case that he be allowed to recover the costs of the litigation from the Federal Government.

If this is done, I believe that a number of taxpayers will defend their rights, and we will see less opposition to the enforcement of the law than we presently witness.

Another point I would like to make is that when the present Internal Revenue Code was put into effect and the $600 personal exemption was established, that $600 went a lot further than it does now. I have a table showing what has happened to these personal exemptions over the years. The present $600 level was established in 1948, and it needs to be sharply adjusted upward in order to establish the same relative position that the taxpayer had when that level was established.

I realize this probably could not be done all at once, but it needs to be undertaken, and we should be able to make the adjustments year by year until we reestablish the position that the taxpayers enjoyed back in the late 1940's.

I would recommend that the committee consider tying personal income tax exemption to the cost of living, so that as the value of our money goes down, this personal income tax exemption would be adjusted upward.

Now, then, there are two industries that I feel the law, as written or passed by the House, are particularly damaged. These happen to be the two industries that are most important to my own State of Oklahoma, and I refer to agriculture and to the mineral and energy industries. Both these industries have done a remarkably good job, during these recent years of inflation, of holding down their prices.

Many foods are selling at or near the levels of 1950. We 'have not seen costs of gasoline go up nor fuel costs go up substantially. They have not kept pace with other increasing costs in our society, and yet this tax bill would place very heavy additional burdens on these two industries, and probably result in higher food costs and higher fuel costs.

First of all, so far as agriculture is concerned, the plain fact is, and I speak from personal experience, that agriculture has not been a profitable enterprise for the last 15 or 20 years. We just have not been able to generate the capital that we need to continue developing our lands, conserve our soil and water, and develop the new plant varieties and the new breeds of livestock that a prosperous and progressive agricultural industry needs. If we drive away the outside capital that is presently attracted into agriculture, we are going to tend to freeze our productive capacity and make it impossible for agriculture to keep up with the growing food needs of our Nation as well as the nations that depend upon us for a part of their food supply.

You can say about the same thing so far as the mineral and energy industries are concerned. I have in my testimony a quotation from Mr. Andrew Fletcher who is the owner, chairman of the St. Joseph Lead Co. This is testimony he made before the Subcommittee on Minerals, Materials and Fuels of the Senate Interior Committee, and I would like to refer to some of the things he said.

He says, "In the last 30 years that this country has used more of these resources"—that is minerals and fuels—"than were consumed by the entire people of the world during all previous history."

He says, "In the decade from 1965 to 1975 it is estimated that our mineral consumption is going to decline by 40 percent."

He cites the fact that it is only the same distance ahead to the year 2000 as it is back to the beginning of World War II but that if we look ahead to the year 2000 we will find that our consumption of zinc is going to go up by 375 percent, our lead consumption will go up by 200 percent, iron consumption will go up 175 percent, our coal consumption will increase 250 percent, and copper consumption is going to go up over 200 percent.

He makes the point that it takes a fantastic amount of money for a company to find and develop these resources and that unless we do make it possible for companies to have the capital they need, that we are not going to be able to provide for our need now or provide for the future.

Now, the same thing can pretty well be said about the petroleum industry. There was a time when it was reasonably easy to find oil in this country, and deposits once they were discovered were shallow and fairly inexpensive to develop. But when you look ahead, we face an entirely different situation.

In my own State of Oklahoma recently a well was completed out in what is called the Anadarko Basin and the cost of this well was something over $6 million. At the same time another company completed a well in the same general area. It was a dry hole. The first one was a producer but the second one was dry. The dry hole cost more than $10 million, so I believe this shows the fantastic demands for capital that the industry must have as it looks for these more difficult deposits that are located at such great depths.

Secretary Udall very succinctly summed up the situation we face as far as petroleum is concerned in a speech he made before the National Petroleum Group Council in March of 1966. I would like again to quote from some of his remarks. He says:

We are going to have to add 82 million barrels to our proven reserve between now and 1980.

He claims that we will need 6.9 million barrels of oil per year in 1980, and he shows that the most we have ever been able to add to our reserves in any one year was back in 1951 when we added 4.5 billion barrels and that over the average during the year between 1955 and 1965 was 3.3 billion barrels, so the only conclusion you can reach is that we are using our oil much faster than we are finding it, and the day is rapidly approaching when we will not have the reserves we need to produce for our own consumption.

He mentions the same case so far as natural gas is concerned, showing that we need about 30 trillion feet a year, and we have been finding about 23 trillion feet a year so we are using gas much more rapidly than new reserves are being found.

He concludes by saying that, "The implications of this imbalance are for a general deterioration of the Nation's capacity to supply itself with crude oil."

He says "No precipitate near-term crisis is in process and the deficits could go on accumulating for several years but it is clear that sooner or later the accounts must be balanced. No industry can go on indefinitely shortening its stocks in the face of a steady rising demand for its products."

So far as my own State of Oklahoma is concerned, we have contributed a great deal to the energy needs of this Nation, and as a result our State and our economy depends heavily upon these two industries, so anything that cuts back on the incentive to locate, develop, and produce new energy reserves is certainly going to damage our economy as well as the economy of many other States, and certainly the economy of the whole Nation.

We have a study, and I do not believe that it should be all printed in the record, but I would like to present it so that the committee can have it in its files, that we made by the Bureau for Business and Economic Research of the University of Oklahoma.[1]

It shows the impact of changes in the intangible drilling cost and depletion allowance on the independent oil producer in Oklahoma, and these same facts would fit other States where independents are important.

It shows that if these changes which are in the House-passed bill were to go into effect, that it would cut back the operations of independents in our State by 45 percent, and since the independents find something like 70 percent of our oil, this means that within a very

[1] The study referred to was made a part of the official files of the committee.

short time we would see a sharp reduction in the reserves that are available for the use of the consumers of this country.

I believe that the thing the committee ought to consider, so far as minerals and fuels and agricultural industries are concerned is whether or not we want to see this Nation maintain a strong position of self-sufficiency in these vital areas. If the Congress, if the committee and the Congress decide that we want our Nation to become dependent upon imported minerals, fuel and food, then we might want to consider some of the changes that are in H.R. 13270.

On the other hand, if we want our Nation to continue to be well fed and if we want to have the reserve of food that we can export to needy nations, if we desire to have a low cost source of energy from domestic sources for the citizens of our urban centers, and if we want to have available on this continent the sources of minerals which are so vital to our industrial economy, then I believe there is a need to attract more capital in the development and operation of these economically hazardous industries.

Our present tax laws provide incentive for this sort of risk-taking, and I believe that they need to be maintained, and in fact should be strengthened.

Now, I do not want to offer myself as an expert on tax matters, because plainly the members of this committee know much more about this than I do, and certainly they have the access to a very well-qualified staff, but I would like to suggest one possibility so far as helping this Nation retain a strong positions in minerals and fuels.

Some of you gentlemen are landowners and you know that if you sell a portion of your land that our present law allows you to treat the income from the sale of this land as the sale of a capital asset and you pay taxes under the terms of our capital gain law, but if on the other hand you are the owner of an ore body, and if you sell a quanity of your ore, you must show the income from this source as current income, and pay the tax after deducting a certain amount for depletion allowance.

Now I believe that one way that the Congress could provide for a stronger national position so far as minerals and fuels are concerned would be to allow the treatment of sale of petroleum or ore from a reserve to be treated as the sale of a capital asset and tax the income from these sales under the terms of our present capital gain law. I would like to suggest that the committee leave the depletion allowance where it is and make a provision so that if the taxpayer chooses as an option that he could treat the sale of these products as sales of part of his capital, because they certainly are in that category.

One other point, and that is having served as Governor of a State as some of the rest of you have, I am fully aware of the growing needs of States and local governments, and I know from first-hand experience how frequently our local and State governments use the funds they receive from the sale of tax-exempt municipal bonds.

I do not believe that our State could come close to providing for its needs if we did not have access to this capital. We could not build our hospitals or sewers or educational facilities or provide any of the other services that our citizens demand. I am very much opposed to the Federal Government putting a tax on municipal bonds under any pretext. I believe that we should encourage States to meet more responsibilities and not make it impossible for them to meet the ones they already have.

To conclude my remarks, I would like to suggest that the committee do everything it possibly can to simplify and clarify our laws and accelerate the development of the country. I feel that H.R. 13270 has exactly the opposite effect, and I believe that the Senate can do a very great service to the Nation by changing the direction and the emphasis of this proposed legislation.

That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator. I appreciate your testimony here today.

Now it seems that I am playing musical chairs with the junior Senator from Maryland, Representative Charles McC. Mathias, Jr. I just came from a hearing where I was presiding as the subcommittee chairman, and Senator Mathias was testifying in favor of confirmation of one of his valued constituents. I am pleased to see he is here.

I do not know whether he beat me to the committee room or not. This is not my first appearance in the room today. We are pleased to have you.

Senator HANSEN. Mr. Chairman, if I could be permitted I would like to ask our distinguished colleague, the junior Senator from Oklahoma one question. I think he has made an excellent statement. May I ask one?

The CHAIRMAN. Go right ahead.

Senator HANSEN. I would like to ask you, Senator Bellmon, do you have any direct knowledge of what might happen in this country if we were to begin to depend substantially upon imported oil and minerals for our industrial needs? It has been proposed that we could lower the price, that there is good reason to look toward outside sources for these energy needs, and those who propose it see no danger at all. In your experience have you any reason to arrive at any fixed conclusion in this respect?

Senator BELLMON. Senator, there are several examples of what happens to our country or any other country when they become dependent on critical strategic materials from outside sources. We all know what happened in this country when the Suez crisis shut off supplies of petroleum. I had a little personal experience in this same field.

When I left the Governor's office I became involved with a small company that makes parts from copper, and just after we got into business and took our first contract, there was a copper strike so that there was no longer a source of copper from domestic sources.

The Government at that time turned loose a substantial amount of the copper we had stockpiled here, but even so, we had to import a lot of copper. The first order we bought, which was before the strike began, the particular compound we were using cost us 74 cents a pound. That was on the 5th of November 1967.

Then the strike came along, and on the 8th of March 1968 we had to buy another order, and by that time the price had jumped exactly 50 percent. It had gone up to $1.11 a pound. Then the next time we bought was in November of 1968, by which time the strike was settled and our own mines were back in production and the price had gone back down to 78 cents a pound. So during this period of time when suppliers of some other countries knew that we had to buy copper, they proceeded to raise the price 50 percent, and we of course lost heavily in our balance of payments, but I believe exactly the same thing would happen if we became dependent upon other outside sources for any mineral that was not available domestically.

I also believe that if we become dependent particularly for energy, that one of three things would happen. We would see these other nations raise their prices, or they might propose to use their position for bargaining in such a way that it would be very disagreeable to us, or we would have to raise the price of petroleum here in our own country so that we could bring the oil shales or the tar sands into production. In either case our customers would be very seriously hurt.

Senator HANSEN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I am not going to ask any questions, because we have 15 more witnesses to hear in this morning's session, but I want you to know that I am basically in agreement with your testimony. I hope that you are able to save the petroleum industry for the benefit of the great State of Oklahoma. If you cannot save it for their benefit I hope you will try to save it for the benefit of Louisiana.

Senator BELLMON. Senator, I think we are saving it for the benefit of the customers more than the people that produce it. We will manage in our State. We will have enough oil to keep our houses warm and our cars running. The people who ought to be concerned are the ones who live in the cities who are a long way from the oil and gas fields.

If our pipelines begin to go dry we will take care of ourselves but the customers who are quite a ways from home ought to look to this.

The CHAIRMAN. Thank you very much.

Senator Mathias.

STATEMENT OF HON. CHARLES McC. MATHIAS, JR., A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MATHIAS. Thank you very much, Mr. Chairman. It is an honor to follow Governor Bellmon at the witness table here. I regret that I have to impose myself upon you twice in one morning in different characters, but I am very grateful, Mr. Chairman, to you and to members of the committee for a few moments to discuss some of the problems of this tax bill.

Before I do that, I would just like to express to the committee on the record my appreciation to Mr. Vail and to the members of this committee's staff who have been extraordinarily kind and cooperative during the last few months, when taxes have been so enormously important to all of our constituents. I am sure our office has put an unusual burden on your committee staff with questions and requests for information. Every member of the staff has been exceedingly helpful to us, and I want to thank both the committee and the staff.

Mr. Chairman, I approach this opportunity to discuss taxes with you with some diffidence. I used to know something about taxes when

I earned a living practicing law. At one time I was Assistant Attorney General of Maryland in charge of the comptroller's office. I thought then that I knew a little about the theory and practice of tax law, but that has been a long time ago, and so it is with some diffidence that I appear here today.

I have prepared a statement which, with your permission, I will simply file with the committee.

The CHAIRMAN. Senator, we have printed all the statements. As a matter of fact, I am pleased to say that your statement is in the record starting at page 8–A. I do not know why it should be 8–A rather than just 8, but there it is. It starts at that point, and it is our duty to read the statement. Anybody who has not read it should read it by now.

Senator MATHIAS. Since it is there I am not going to read it today. I would like to flesh it out very informally.

The CHAIRMAN. I am pleased to say it is not a very long statement. Anybody who has any intellectual curiosity at all can read it in a hurry which I think is a credit to you. You do not just waste a lot of time shooting up the landscape without hitting a target.

Senator MATHIAS. It is the barebones of what I have to say.

Senator GORE. You are not opposed to shooting up the landscape, are you, if it is necessary?

Senator MATHIAS. It all depends on the circumstances.

Senator GORE. I thought I noticed some scattergun tendencies of yours now and then.

Senator MATHIAS. I do not like my tactics to show that much.

Mr. Chairman, I have selected just a few points that I want to comment on here today. As I noted in the statement, these are by way of illustration of my concern rather than by way of limitation of it.

Let me say that on the question of philanthropy and how the tax bill is going to affect it, we have to approach the changes in H.R. 13270 with enormous caution. For example, the whole character of the city of Baltimore is set by several institutions which are products of philanthropy:

The Johns Hopkins University and Johns Hopkins Hospital, the Enoch Pratt Library, the Walters Museum, and the Peabody Institute & Conservatory, just as examples.

Now the character of the city of Baltimore has for several generations benefited from these institutions which are the results of philanthropy.

Now, granted they were all established before there was an income tax, but they are maintained today over and above the original endowments in substantial part by philanthropy. If we discourage philanthropy, as I believe the House bill does, we are going to cut off these enormously important institutions which deal with our minds, our bodies, and our spirits, and I think we are going to change a very fundamental aspect of the American character.

We are going to undermine the maintenance of old philanthropic institutions, and I think we are going to virtually prohibit the establishment of new ones.

I talked to a man yesterday who said to me that it had been his habit in recent years to give about $50,000 a year to charity, and he said he was about ready to stop if this bill went through, that he would have to stop.

I would call particular attention to those provisions of the bill which affect foundations which are esta' lished primarily with the stock of closely held corporations. If the provisions of the House bill with respect to those family foundations based on family corporations are to stand unchanged, you will never again have a Ford Foundation. You will never again have a foundation of that character. It could not be done.

I think that there is a considerable social question involved here that can be resolved without totally destroying the concept of getting away from closely held family foundations. We should, however, allow a sufficient period of time, a breathing space in which to move out of that kind of a closely held picture.

Senator GORE. Mr. Chairman, could I ask a question now?

Senator, I agree with you that tax treatment of foundations raises profound social and political questions. In fact, not only does the tax bill raise such questions, the simple proliferation of foundations alone raises them. In a very real sense, today, the dead are ruling the living, and the perpetuity which we have accorded foundations is a violation of tenets which our country earlier found necessary to establish, and which the English, the Romans, the Greeks, and the Hebrews found necessary to establish. We simply must do something to curb the tendency of the rich and the vain and the privileged to undertake to accomplish permanent entailment of a large part of this country's wealth.

Senator MATHIAS. If the Senator will allow me to respond to that, I agree 100 percent with what he has said. In fact the statute of Mortmain is law in Maryland today; when I was a member of the Maryland Legislature we annually had to pass an act to exempt charitable bequests that had been made in Maryland from the statute of Mortmain. This is an ancient principle of the law. I am not for leaving all the tax law unchanged in this respect, but as I have set forth in my statement, I think we ought to do so with some regard for the social impact and for the necessity of cushioning the requisite changes.

The CHAIRMAN. Senator, I think I will get in my one statement now. You know, I am a civil lawyer. I come from Louisiana where we are still going by the old Napoleonic Code. What in the devil is the statute of Mormain? What is that?

Senator MATHIAS. That is a statute of the British Parliament which is in effect in Maryland because it has not been altered or repealed by the legislature since 1776. It prohibits the accumulation of what we today call foundations, but it was primarily originally directed at accumulation by the church in medieval days. Mortmain, deadhand, refers to the dead hand of the church which prevented any alienation of land. Great globs of land lay inert, and it became recognized as a social ill.

Senator GORE. This is indeed one of the great landmarks of Anglo-Saxon jurisprudence.

Senator MATHIAS. That is right.

Senator GORE. It was the culmination of many years of conflict between the church and the Crown.

Senator TALMADGE. Will you yield at that point?

Is that what was known as the rule in Shelley's case?

Senator GORE. Not the rule in Shelley's case but——

Senator MATHIAS. Both of them have the object of preventing the removal of large bodies of property.

Senator GORE. Perpetual entailment.

Senator MATHIAS. From being alienated in some way.

Senator GORE. But the point I wish to make to you, Senator, is that by the device of the foundation, the rich and the vested and the vain and the self-righteous have now found a way to circumvent these landmarks of social jurisprudence, and we must eliminate this circumvention.

Senator MATHIAS. I think it is our object, if I may respectfully submit, to find ways to apply these time-tested principles in wise and prudent ways for the future.

Very briefly on the question of municipal bonds, Mr. Chairman, I know that has occupied your attention.

The CHAIRMAN. If I may say, Senator, I had to ask the question because we Frenchmen never let that mess start to begin with so we did not have to pass a law like that.

Senator BENNETT. Isn't it ironical that the words mortmain are French words?

The CHAIRMAN. They are Latin.

Senator BENNETT. They are French.

The CHAIRMAN. Just look up the spelling of it. You will find it is spelled one way in French and another way in Latin. That is Latin. Go ahead.

Senator MATHIAS. I am not going to get into that argument.

Senator WILLIAMS. I might give the witness assurance that when the lawyers get through with this we laymen will settle the issue for you.

Senator MATHIAS. Mr. Chairman, as far as municipal bonds go, of course, obviously we do create ways of making it possible for very wealthy individuals or for institutions that control large amounts of capital to get this kind of tax-free income, and I recognize the need for some reform in this area.

I would just voice this caution. In attempting to make things more equal, we may not be simply throwing the burden on the millionaire's mansion. The changes proposed in H.R. 13270 may well be felt in every bungalow and rowhouse which has to pay a higher local tax rate because every local improvement is going to cost more because of the higher cost of financing.

With respect to pensions, I urge the committee to give serious consideration to Secretary Kennedy's request for deferring any action with respect to changes in the law affecting nonqualified plans.

Again, I think we are cutting close to the quick of the national character in this field, and I do not say that we ought not to make some changes, but I do say they ought to be considered changes.

You are touching the traditional American quality of industry and frugality and thrift, and these, of course, are personal qualities. But I think we also have to consider the collective impact. The pension plans today and the capital that they accumulate form a pool for the expansion of the American economy. If you dry that pool up, I simply ask the question where will we get the money to continue the growth of our economy in the future? Who is going to provide it?

We built a lot of our initial industrial empire on foreign capital, on money that came from Europe in the 19th century. In the 21st century where will it come from if we dry up our own sources? I do not know.

Finally, Mr. Chairman, and I do not want to take the time of the committee any further, but let me just say a word about livestock. I say that in the State of Maryland we have quality quadrupeds of every kind, horses, cattle, sheep. We have got the best. And I say that with all due respect to Governor Jordan and Governor Hansen and all the fine cattle country that they represent. We have got the best quadrupeds in America, but we are not going to have them if the House version of the tax——

Senator TALMADGE. Don't leave out Senator Bennett. They raise cattle in Utah.

Senator MATHIAS. I do not want to leave out anybody. I do not even want to leave out Senator Williams' chickens.

The CHAIRMAN. If you are talking about the best cattle you can leave out Louisiana. What I raised down there was not worth bragging about so you can just leave us out.

Senator TALMADGE. Tennessee produces some mighty fine Black Angus.

Senator MATHIAS. Just last night I talked to the dean of agriculture of the University of Maryland, and he said that some of the finest cattle herds in Maryland are already planning dispersal sales, and they look forward only to recovering about 20 cents on the dollar, because of the economic impact of what the tax bill would do to the cattle industry.

Maryland was the birthplace of the thoroughbred horse in America. Out here Governor Ogle of Belair just east of Washington brought the first thoroughbred to America.

Senator TALMADGE. Mr. Chairman, may I ask a question at that point?

You know the House bill provides that if you have farm losses of $25,000 in 3 years out of 5, and then nonfarm income $50,000 or more, you cannot deduct the losses. Now, Senator Gore here is in the Black Angus business. As a Senator he has a salary of $42,500 a year, and he may have some other income in addition to that. Do you think that Senator Gore ought to be put out of the livestock business because he is a U.S. Senator?

Senator MATHIAS. Let me preface anything I have to say on that by referring to the——

Senator GORE. I am more concerned with being put out of the Senate.

Senator MATHIAS. That reminds me a little bit when Chick Forrester and Carl Vinson were over the House 1 day and they were talking about farming down in Georgia and Chick said you know Carl only stays in Congress just to support that farm he has down there.

But let me say in prefacing the remark I made that in the Congressional Record I have filed a personal statement of net worth which includes livestock. I have got a few Angus too. I do not know that they compare with Senator Gore's. But I think a farming operation ought to sit on its own bottom, in this respect.

However, mine is of such a small nature that it has no hope of ever reaching the limits that the Senator has described as being disqualifying. I do think it ought to sit on its own bottom.

Senator GORE. Could I interject a remark since our mutual livestock enterprises have been mentioned. It is true that I produce on my farm pure-bred Angus cattle.

Senator MATHAIS. I am a grade man myself. I only produce for the butcher.

Senator GORE. But my business is not in any sense a tax shelter. I have been a breeder of Angus cattle now for 31 years, so you can hardly call this fly-by-night. Mine is a legitimate operation. I raise and sell cattle.

The tax shelter in this field is something with which I think the Congress must deal. The tax shelter is taken advantage of by certain people, many of whom have never been, and do not plan to be, and are not in fact, legitimate breeders or farmers or producers of cattle. We must do something about this, and I am anxious to try to do something about it. But I would not like to see the legitimate farmer and legitimate pure-bred industry so penalized that it cannot continue to provide the improvement of livestock and quality meat in this country as well as other pure-bred enterprises.

Senator MATHIAS. Well, I think perhaps I ought to add a word of personal explanation too, now. The farming operation in which I am engaged is one in which I was associated with my father from the time I got out of the Navy at the end of World War II until my father's death. I have been limping along since that time. It is one out of which I get a great deal of personal satisfaction. I bought my first Angus when I first got out of the Navy from some war bonds I had bought when I was in the Pacific. It is no tax shelter and no gimmick that I have got. I do not disagree with the Senator that this kind of farming ought not to be limited, because it does seem to me that this preys upon the interest of people who are legitimately interested and concerned with a serious farming operation, and creates a kind of artificial competition which I do not think any of us want to preserve.

But I do think that the House bill, particularly with respect to depreciation on livestock, would have an adverse effect on legitimate agriculture, on the horse industry.

I want to get back just one second to the horse industry, because that is important to Maryland. It is important to everybody in Maryland because everybody in Maryland participates in the State's partnership share in State regulated racing, and if the rules of depreciation, the holding period are all changed, it will have a detrimental effect on racing and it could very seriously affect the State's share as a partner in that business.

I am very proud of what we have in the way of livestock farming and animal husbandry in Maryland. As I say we have quality quadrupeds in all departments, and I think this bill will be very detrimental to the quality, to the quality, because I do not think you can keep it up when you pull the economic base out.

Senator GORE. Mr. Chairman, since the distinguished Senator is a lawyer with a great deal of experience in tax law and a farmer, I suggest that we invite him to submit to the committee some practical suggestions as to how we can deal with this problem.

(The following letter was subsequently received from Senator Mathias:)

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C., October 16, 1969.

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

DEAR MR. CHAIRMAN: On October 2, 1969, at the Hearings on H.R. 13270, you asked me to "work something out" for submission to the Finance Committee regarding the controversial questions raised in the "Farm Loss Area" (Transcript Vol. 17, pp. 2565–66.) It seems clear that we must protect the legitimate farmer, while at the same time eliminating the "in-and-outer," *i.e.*, the non-legitimate "farmer-taxpayer" who gets into farming for quick tax deducations and sells out for profitable capital gains tax advantages.

After reviewing various proposals, I commend the following suggestions to the Committee:

1. Include livestock in depreciation recapture, *i.e.*, recapture at ordinarly income rates depreciation taken or allowed in previous years.
2. Extend the holding period for cattle and horses for capital gains purposes from:
   (*a*) 12 to 18 months or 24 months, or
   (*b*) Provide the holding period for all livestock for capital gains purposes be six months from time of first normal use for draft, breeding, dairy or race purposes.
3. Prevent tax-free exchange of male calves for female calves.
4. Require taxpayer proof that said animal or animals were actually held for breeding purposes in order to claim capital gains.
5. Where farm land is held for less than ten years, require a sliding scale recapture at ordinary income rates of land improvement expenses which had previously been deducted.

By proposing that all livestock be included in the depreciation recapture provisions of the code, livestock will be put on a par with all other depreciable business assets. I believe this provision will eliminate the tax profit from those tax avoidance schemes which are designed to trade depreciation deductions during the early part of the useful life of an animal against capital gains on its premature sale.

If a breeding animal is held to its full useful life there should not be *any* gain on its sale since it will normally be sold at salvage value. Thus, most of the legitimate stockmen who remain in the business and retain their purchased animals for their full useful life will not be affected. But the "in-and-outer" is *directly* affected because most of the gain realized at his premature sales will be taxed at ordinary income rates.

By increasing the holding period of cattle and horses from twelve months to eighteen or twenty-four months, the tax profit of the "in-and-outer" will be substantially reduced or almost eliminated. This would discourage the "tax profiteer" from getting into the livestock business solely to build up a breeding herd over a period of a few years, deducting currently the expenses of raising the animals against outside high tax bracket income, and then selling out the entire herd at the end of the period at capital gains rates. Under this proposal the tax gimmick investor would be "locked in" for several years to realize any capital gains, while other investments would be much more appealing to him since only a six or twelve month holding period would be required for capital gains treatment. Alternate proposal (2.b) above would also reduce the tax profit incentive for the typical tax profiteer while still protecting *all* legitimate livestock farmers from discriminatory tax treatment.

By requiring that the exchange of male calves for female calves is not a tax-free transfer, the tax gimmick promoter would be deprived *by statute* of one of his often used tax promotion schemes. (There is at least one court case which has upheld such transfers as being tax-free, thus lending support to this tax gimmick scheme.)

By *statutorily* requiring that the taxpayer has the burden of proving that he really held the livestock for breeeding purposes for the required length of time, the tax gimmick investor has a burden which will discourage, if not prevent, his continued search for Farm Loss tax avoidance schemes.

Where farm land is held for *less than ten years*, by requiring a sliding scale recapture at ordinary income rates of land improvement expenses previously deducted, the "in-and-outer" is further discouraged from entering this business for tax gimmick advantages. This provision also directly affects the "in-and-outer" tax dodgers of the *citrus industry*. Most legitimate farmers hold their land for periods exceeding ten years.

The above provisions seem *simple*, *understandable* and *easy to enforce* and *administer*. While they might not meet with 100 percent approval of every legitimate farmer, over 90 percent of the livestock and horse industry would probably support them. The provisions go further than the Farm Loss provisions of Senator Gore's Bill (Sec. 13 of S. 2645) to *ensure* the plugging of the "tax gimmick" or "tax profiteer" loopholes of existing law.

The adoption of these provisions would, of course, delete Sec. 211 (The Excess Deductions Account) and Sec. 213 (the new Hobby Loss Presumption) from H.R. 13270. I believe they should be eliminated because:

(*a*) They are too complicated and discriminate against and amongst legitimate farmers.

(*b*) They would require millions of farmers to keep two sets of books (cash and accrual) which is an impossible burden to put on the legitimate farmer.

(*c*) They are unnecessary if the other provisions are adopted by the Committee. I believe the suggested provisions would eliminate the tax gimmick operator, the "in-and-outer," from the farm and ranch business completely and permanently.

I have enclosed copies of statements by E. Brooke Lee, of Damascus, Maryland, and the Upper Montgomery County (Maryland) Farmers Club, which I would appreciate your placing in the official Hearing Record.

Let me reiterate my compliments for the outstanding and thorough job the Committee has been doing in the massive task of tax reform.

With best wishes.

Sincerely,

CHARLES McC. MATHIAS, Jr.,
U.S. Senator.

The CHAIRMAN. I think that, if the Senator from Tennessee would get his head together with the Senator from Maryland about taxing cattle and horses, I would think that they could work something out.

As far as I am concerned, I do not own any. I own one horse. At least I once owned a horse.

Senator GORE. Can I sell you another?

The CHAIRMAN. I learned my lesson the hard way. But if you could get together with the Senator to find some way to get some money out of these horse-and-cattle farmers why that would please a lot of us who found we could not make any money in that business.

Senator MATHIAS. Let me say I have not found any way to make any money out of it, either, and I have no horses. I have no personal interest of any sort in horses, but it is a matter of concern not only to the individual Marylanders, but it is a matter of concern to the State, because the State is a partner in the horse business.

Senator GORE. We are not talking about our personal interests. We are talking about the problem of people who are engaged in this industry.

Senator MATHIAS. Absolutely.

Senator GORE. I will be glad to talk with you and try to work this out.

Senator MATHIAS. I appreciate the Senator's invitation.

The CHAIRMAN. I want the record to show that just bceause Senator Gore manages to make some money in cattle it does not mean that everybody can do it.

Thank you very much. Senator Miller?

Senator MILLER. I just want to find out from my colleague whether the main thrust of his concern with the House bill concerning livestock has to do with the proposed changes on capital gains recapture, rather than with the attempt, not necessarily the language of the House bill but the attempt to do something about the writing off of farm losses agains high-bracket nonfarm income.

Senator MATHIAS. The Senator perceives what I was attempting to do. My concern is primarily with the capital treatment of livestock of all kinds, notwithstanding shelters which are built up by farm losses, which I agree should be limited and should be segregated from other activities.

Senator MILLER. I share my colleague's feelings about this very strongly. Thank you.

(Senator Mathias, Jr.'s prepared statement, with attachment, follows:)

STATEMENT OF SENATOR CHARLES McC. MATHIAS, JR.

SUMMARY

I. PHILANTHROPY

H.R. 13270 is a severe challenge to spirit of philanthropy. Reported abuses of tax exemptions justify better oversight and auditing but not a wholesale assault on the voluntary sector.

A. Limit on charitable deductions should be raised to 50 percent of adjusted gross income as in H.R. 13270. Administration's recommendations on charitable trusts and gifts of appreciated property are substantial improvements over House bill but more modifications should be considered. Gifts of appreciated property to foundations should not be in separate, prejudicial category.

B. In regard to foundations:

1. Proposed tax on investment income should be reduced to 2 percent, as recommended by the Administration, and explicitly imposed as a user charge or fee to defray auditing programs.

2. Provisions requiring 5 percent yield are unrealistic and could be mischievious. More flexibility should be permitted.

3. Stock ownership limitations of H.R. 13270 would impose real hardships on private foundations whose assets consist of stock in closely-held family corporation and whose major contributors are family members. If attribution rules remain so broad, such foundations would have to dispose of all such stock even if non-voting stock. Legislative mechanisms are needed to permit redemption by the issuing corporaton in such cases without adverse tax effects to the foundation, the corporation, its stockholders or the original donor of the stock.

4. Rules restricting foundations' activities in public policy fields should be clarified and rationalized.

II. STATE AND MUNICIPAL BONDS

H.R. 13207's proposals have already caused chaos in the load markets. Congress should not make any changes which would increase difficulties for state and local governments in financing needed capital improvements.

III. PENSION PLANS AND DEFERRED COMPENSATION

A. Present tax treatment of lump-sum distributions from qualified pension plans should not be changed.

B. As recommended by Secretary Kennedy, changes in tax treatment of deferred compensation plans, proposed in sections 331 and 541 of H.R. 13270, should be dropped pending further study of overall economic impact.

IV. LIVESTOCK

Proposed changes in capital treatment of income from sales of livestock would create havoc in an industry already beleagured with economic problems.

STATEMENT

Mr. Chairman, it has been said that a real opportunity for tax reform comes only once to each generation. If this is true, this is our opportunity and we must use it well.

H.R. 13270 is undoubtedly the most far-ranging bill we shall consider this year. As the mail pouring into our offices testifies, there is great public concern over the growing weight of taxation—Federal, state and local—on the nation's wage-earners. As the mail also indicates, each section of this bill will have a lasting impact on some segment of our economy and society. Thus our task is the difficult one of balancing general concepts and specific complaints, and producing an equitable and durable bill.

I claim no special expertise across the whole spectrum of taxation, and I would therefore like to confine my remarks today to four areas which are of deep concern to me and to many Marylanders: philanthropy, state and local bonds, pension plans, and livestock. I choose these subjects not out of any limitation of interest and concern, but out of a limitation of your time.

I. CHARITABLE CONTRIBUTIONS AND FOUNDATIONS

The House-passed bill constitutes a severe challenge to the philanthropic activities which have been a uniquely American asset throughout our history. As far back as the 1830's, Alexis de Tocqueville noted the tendency of Americans to form voluntary associations to meet public needs. This week the launching of annual United Givers Fund campaigns across the nation reminds us again of the tremendous contributions which the voluntary sector has made to our social health and national welfare.

The spirit of philanthropy has built and sustained many of our greatest educational and medical institutions. It has founded and supported many of our finest libraries, museums and orchestras. It has enriched our cultural life and underwritten many valuable community services, such as scouting and the Red Cross, which otherwise would have to be provided by government or not at all.

Private foundations have been a vital expression of this philanthropic spirit. As HEW Secretary Robert Finch wrote recently:

> In every area of thought and action—in all the arts and sciences, in basic research, in public health, in scholarship and creativity, in the building and preserving of independent social institutions—the catalogue of foundation-supported efforts provides many benchmarks in the progress of recent civilization.

It is true that a few individuals have used charitable contributions or created foundations to reduce their tax burdens excessively. Also, a few foundations have abused their tax-exempt status. Such excesses do justify improvements in the laws and far more extensive oversight and auditing of tax-exempt activities. But they do not justify, in my judgment, a wholesale assault on the voluntary sector—especially at a time when government's social burdens are already vast, or when diversity and innovation should be promoted rather than squelched.

A. In regard to charitable contributions, therefore, I support the House provision which would increase the limit on charitable deductions from 30 percent to 50 percent of adjusted gross income. I am concerned, however, about other provisions of the House bill which could discourage very large contributions, the creation of charitable trusts, and gifts of appreciated property, including works of art and literature. The Administration's recommendations to this Committee represent a substantial improvement over the House bill, but further modifications should be considered.

In particular, I cannot understand any justification for placing in a separate and prejudicial category gifts of appreciated property to private foundations as opposed to similar gifts to other types of tax-exempt entities.

B. In regard to foundations, I am especially troubled by four aspects of H.R. 13270:

1. The proposed tax of 7½ percent on the investment income of foundations is to me excessive and unwarranted. I therefore support, as a compromise, the Administration's recommendation to reduce this to 2 percent. To maintain the traditional tax-exempt status of foundations and other philanthropic institutions, moreover, I believe that such a levy should be clearly and explicitly imposed as a user charge or fee, earmarked to defray the administrative expenses of auditing

and examining exempt institutions. Such an approach would support a fully adequate IRS auditing program. It would also avoid encouraging states and localities to follow the Federal lead by attempting to tax this one portion of the universe of tax-exempt institutions.

2. The "income equivalent" provisions requiring a minimum 5 percent yield for foundations is unrealistic and could be mischievous. Foundation managers were obliged to maintain a prudent investment portfolio which would, presumably, include a mixture of growth and income-producing investments. The House bill would upset this management concept and could lead foundation managers to chase the vagaries of the stock market in pursuit of a 5-percent return, rather than concentrating on their philanthropic responsibilities. Far more flexibility should be permitted.

3. The stock ownership limitations of section 101 of H.R. 13270 would impose special hardships on private foundations whose assets consist wholly or primarily of stock in closely-held family corporations, and whose major contributors are members of that family. Even where these holdings are of non-voting stock, the extremely broad attribution rules of the House bill would require such a foundation to dispose of all its securities in the family corporation, because of the stock held by family members. Presumably the funds received in return would then be reinvested by the foundation in other securities not usbject to the 20-percent limitation.

I am not convinced of the necessity of such complete divestiture where the stock involved is non-voting stock. However, I am more concerned by the fact that in such cases, compliance with these provisions would be extremely difficult since no ready market would exist for the non-voting stock other than the family or the issuing corporation. Realistically, only redemption by the issuing company would provide the foundation with a reasonable value for the securities held.

While the House bill does not forbid such redemption by the issuing company, the Internal Revenue Service has sometimes taken the position that where a corporation redeems shares which have been received by a foundation as a gift, the redemption amounts to a dividend taxable to the persons who made the gift. As far as the redeeming corporation is concerned, there is a possibility that the IRS would assert the penalty tax for unreasonable accumulations of income. The uncertainty of this situation is extremely dangerous and could effectively prohibit redemption as a practical matter.

At the very least, therefore, an explicit leigslative mechanism should be provided to allow redemption by the issuing company in such cases over the 10-year period with no adverse tax effects to the foundation, the redeeming corporation, its stockholders or the original donor of the stock involved. In related areas, too, I would encourage this Committee to provide the required assurances to permit such foundations to comply in good faith with the concept of divestiture without incurring penalties for their compliance.

4. Finally, I urge this Committee to clarify the highly confusing and ambiguous language of the House bill restricting the permissible activities of foundations in public policy fields. The line between lobbying and educational activities is a delicate and elusive one, but—as Secretary Finch has stated—a rational definition must be found. It would be a real mistake, I feel, to discourage foundations from sponsoring innovative efforts in education or medical research, or to deny legislators and public administrators the benefits of the experience and knowledge of many eminent Americans simply because those individuals are connected with foundations. For example, under some interpretations of the House bill, public officials could discuss the Heller-Pechman revenue-sharing proposals with Dr. Heller, who is at a university, but not with Mr. Pechman, who is associated with a foundation. Such inane situations should be precluded by clarification of these provisions.

II. STATE AND MUNICIPAL BONDS

A second area of special concern to me is the proposed change in the treatment of interest on previously tax-exempt state and local bonds.

In 1968, $16 billion in such bonds was issued to finance a portion of the vast capital needs of our nation. The tax bases on which state and local governments depend are already overburdened. In this context, I believe we should be extremely cautious in considering measures which could make it even more difficult for states and localities to finance much-needed improvements such as schools, hospitals, streets, libraries, and water systems.

The mere discussion in Congress of removing the traditional exemption from these bonds and of including such income in the LTP and allocation of deductions provisions has engendered chaos in the market. In the period from February to August 1969, the Bond Buyers' Index of 20 representative municipals rose from 5.04 percent to 6.02 percent, a considerably larger jump than occurred in federal and corporate debt financing. As our colleague from New York pointed out before this Committee, the market rate of return on state and local bonds has been steadily rising. It would appear that the revenue effect of the proposed changes may not be great, but that the market effect could be catastrophic.
but that the market effect could be catastrophic.

If we are to design a true tax-reform measure, we must not force local governments to abandon bonds and turn to increases in regressive sales, property and utility taxes.

Protracted litigation to test the limits of the doctrine of "intergovernmental immunity," regardless of the eventual outcome, promises to keep the municipal market in confusion for years if changes similar to those in H.R. 13270 are ultimately enacted.

Federal grants-in-aid for capital purposes in F.Y. 1970 will total some $6.5 billion. The bulk of the required matching funds will be raised through bond issues. As the Federal government holds out promises of revenue sharing, a mass transit fund, and welfare reform on the one hand, it must not seriously erode a significant source of state and local government financing on the other.

III. PENSION PLANS

Since 1942 lump-sum distributions from qualified pension plans and similar sources have been accorded capital gains treatment. The House bill would prospectively limit such treatment to the amount in excess of employer contributions.

The fact that these distributions involve receipt in one year of funds accrued over a number of years suggests that the entire amount should continue to be taxed at special rates. I am confident that this Committee will carefully examine the relevant portions of H.R. 13270 to insure that the reasonable expectations of the numerous employees participating in such plans are not thwarted.

I am concerned that other changes in pension treatment called for in H.R. 13270 may have broader ramifications than initially appear. Future growth in the private sector of our economy is dependent upon the availability of a large pool of capital which will enable older businesses to expand and new ventures to be created. Any narrowing of this pool of capital should be regarded with concern if we are to keep what will soon be a trillion-dollar economy growing in a healthy manner. Profit-sharing and pension funds have increasingly become important sources of capital for investment in the private sector.

Before any further limitations are placed on deferred compensation plans, considerable study should be given to the effect of such limitations upon this pool of investment capital. I therefore endorse the request of Secretary Kennedy that changes in deferred compensation plans proposed in Section 331 as well as in Section 541 (referring to subchapter S corporations) be dropped from the bill for further study.

IV. LIVESTOCK

Finally, I am concerned about proposed changes in present capital gains treatment of income from the sale of livestock. Lengthening the required holding period and including livestock in the depreciation recapture rule could create considerable havoc in an industry already beleaguered with economic problems. Here, as in the case of foundations, we must avoid penalizing the vast number of legitimate operations to reach alleged abuses by a small number of taxpayers.

Mr. Chairman, in conclusion, I wish to congratulate you and this Committee and its staff for the intensive scrutiny you are giving to this massive bill and the hospitality you have shown to all witnesses. I look forward to working with you toward the enactment of tax reform legislation which will promote the interests of tax equity and our national economic health.

I have enclosed a copy of a statement of E. Brooke Lee, of Damascus, Maryland, with an attached resolution of the Upper Montgomery County (Md.) Farmers Club.

STATEMENT OF E. BROOKE LEE, OF DAMASCUS, MD.

The development in this nation in recent decades (with the past 30 years operating under the present provisions of the federal income tax laws) of greatly improved American dairy cattle and beef cattle have furnished the American people with better products of these two most essential foods. Cattle improvement has helped through increased food production per pound of cattle feed and per head to keep these basic foods abundant and to limit their increased cost to the American consumer more than has been the case of most other essential consumer foods or needs.

The present tax bill now pending in the Senate will greatly damage most farmers, most dairy farmers, and most beef cattle producers. The terms of the House bill will, in all probability, drive from the American beef production business those breeders of the half dozen major American beef breeds who have non-farm income of over $50,000 a year. This group has throughout the past century made a most important contribution to the improvement of American beef herds from which all Americans have benefitted.

Several of the provisions which will drive such breeders out of the beef production and beef improvement business are largely punitive because the same tax reform law, as passed by the House, does not propose to apply such harsh terms to other types of American producers of essential products; and further because in several of the most burdensome proposed punitive measures the yield in estimated new taxes by the Treasury is small and out of all proportion to the proposed damage and expense to the farm producers. For example, the pending bill requires at least three times as long a holding period for a beef animal sold for breeding purposes to entitle that sale to capital gain treatment as it proposes to continue to require for a share of stock or a structure.

The bill ignores completely the basic requirement in the production of improving beef cattle, which is to put together a combination of genes, of feed, of pasture, of exercise, of sanitary conditions, of inoculations against many modern diseases and several dozen other factors, before a producer or breeder can offer an animal of an improved beef producing type of any breed of American beef cattle or of any combination of cross-breeding.

When such a result is accomplished, it is a marked benefit to all animals within range of that result. Very clearly any improved type of beef animal good enough to be sold for breeding purposes has earned consideration from beef consumers or beef producers and the owner who has spent the money and done the work to produce the improved beef animal has earned an equitable position from which he should be allowed to sell such a type improvnig beef animal on a capital gain basis with a similar holding period as required for stocks or structures. The improved beef animal is much more difficult to produce and is capable of much more general benefit to more citizens.

Contrary procedure is so discriminatory as to be a reversal of all previous concepts of American taxation and will undoubtedly drive from the business of helping improve all types of American beef animals those individuals who have any substantial non-farm income. Sensible men will not be willing to take the risks concerning improved cattle production which the Treasury has caused to be written into the pending tax bill as it passed the House.

Animals raised for slaughter should continue to be classified as producing ordinary income at time of sale and animals sold for breeding should continue to be classified as entitled to sale on a capital gain basis or both future dairy and beef improvement will be badly hurt by the action of the Congress.

Certain provisions of the tax reform bill, as it passed the House of Representatives, are highly detrimental to the livestock industry. Certain others are largely punitive and also highly detrimental to the livestock industry and in the estimates furnished by the Treasury to the House Ways and Means Committee produce relatively small amounts of probable increased tax. Among such items are—

A. The excess deductions account (EDA) which eliminates capital gains on farm assets.

B. The change in the "hobby" loss farm provision which cuts it from $50,000 and five years to $25,000 and two years.

Since the bill strictly limits the amount of farm loss that can be considered to offset non-farm income, the amount that a breeder of registered cattle losses in any year or in any several years does not seem to be a question of federal taxation. The loss is that of the citizen who engages in the business of producing registered beef cattle and the loss does not affect materially the total amount of tax that such a citizen will pay. Consequently the purpose of this provision appears to be largely punitive.

C. The limitation on tax preference that is familiarly known as LTP.

Few farm operators who produce different types of farm produce or who produce cattle with several types of tax status can determine the exact cost of either type of product or cattle. That is, cost can only easily be determined when cattle are bunched up as in feed lots or are runing in one herd with one status or destination, or wheat in a wheat operation, or milk in a dairy operation, etc. Consequently the principal requirement of this limitation is regarded as most difficult to fulfill and extremely expensive to accomplish and so largely punitive in nature. For example, such accounting would require the break-down into hourly allocations of farm workers. The Treasury estimates only indicate an expected increased revenue of from $5,000,000 to $20,000,000. The cost to farmers is estimated to greatly exceed the larger estimate.

D. The allocation of deductions.

The combination of items A, C and D, if enacted, is expected to be fatal to the continuation in the cattle busines of a vast number of present beef producers and to be practically certain to eliminate a larger proportion of the continuation of the individuals who have during the past 30 years have produced the registered improved beef strains that have made the American beef cattle the best and the most economical producers of good beef in the world.

Actually the combination of A, C and D appears principally to be a determination on the part of the Treasury to force farmers to keep separate accrual sets of books even when operating on a cash basis. It is believed that few can keep accrual books for most farming operations and that the cost of such an effort will run into the tens of millions of dollars.

The procedure proposed to be forced in this maner is discriminatory against farmers in general and cattle producers in particular, due to the continuing fact that under the tax reform bill other producers are not so proposed to be driven off their long-established cash accounting systems.

UPPER MONTGOMERY COUNTY (MD.) FARMERS CLUB RESOLUTION UNANIMOUSLY PASSED SEPTEMBER 27, 1969

Be it resolved, That the United States Senators and Members of Congress from Maryland be petitioned to use their best efforts to eliminate from the now pending tax bill a series of discriminatory and even punitive provisions against farmers and livestock producers which include the following:

1. The tax bill as it passed the House of Representatives includes a particularly punitive program against operating farmers described in the bill as the Excess Deductions Account provisions, through which proposed procedure many new additions are made to the operating cost schedule of farmers who are on a cash account basis (as nearly all farmers are), and which new charges to farmers continue to stand under the same bill as tax deductions rather than tax charges to Americans engaged in other occupations or industries. For example, interest on borrowed money against the farm or the farmer will for the first time be added to the accumulative Excess Deductions Account with an effort to ultimately recapture same as taxes as part of Federal taxes against the sale of the farm land or future farm production.

In the case of any commercial structure, manufacturing operation or individual business venture interest continues as a straight deduction before the calculation of any tax. Yet against the farm value in the reform bill it is to be set up as a recapture weapon should the farm value increase at ultimate sale.

Another punitive feature of the Excess Deductions Account is the demand made through that procedure to treat the value of unsold livestock, cattle or horses, as accrued and taxable income before the animals in question are sold. Such a rule generally does not apply to other merchandise and in the case of livestock the uncertainties both of prices and survival plus the small margin of profit to the producer are such that this presale method of taxation will, we are sure, prove an unbearable burden to the farmer and producer.

We respectfully petition the members of the Senate and Congress to work to eliminate these new destructive and even punitive discriminations against farmers in general and livestock producers in particular.

For example, it would be equally logical and equitable for the Internal Revenue Service to insist that each bushel of grain or ton of hay be considered as taxable income when harvested and not when sold, with date of sale prevailing in other walks of American industry. Such a provision of course would increase the confusion and the injustice to farmers but it would be no more illogical, inequitable or punitive than the present proposals concerning the producers of cattle and horses.

2. Substantial reductions in the portion of the sales price of a farm or of livestock that can be treated as capital gains as compared to the rules concerning same that have prevailed since the income tax was attached to these types of property.

In this connection we observe that the principal substantial profit that most farmers or farm families are able to make in the United States today is represented by the value of the farm property. These farms are generally held for many years and even generations in the ownership of the operating family. To change the law to treat so much a larger patr of any profit that may appear in the sales price of such a farm as ordinary income, and taxable at the highest rate authorized by the Congress, will work a great hardship on the heirs and, owners of all farm property and will greatly discourage the efforts of countless families to work to hold their farms and will most definitely discourage a most substantial portion of any nationwide interest to invest in farm lands.

We regard these provisions as extremely detrimental to the values and the stability of the ownership of the farming sections of Maryland and of the Nation.

3. The bill as it passed the House practically eliminates the long existing opportunity to sell breeding cattle or horses on a capital gain basis through the discriminatory expedient of requiring the selling owner to hold the animal in question for an arbitrary period of a year or more beyond the age at which most similar animals are now customarily sold and apparently for the sole purpose of denying the producer the opportunity to sell cattle or horses on a capital gain basis. The arbitrary, unrealistic and punitive period set up for this purpose in the bill as enacted by the House is some three to five times longer than continues to be required for the holding of market stocks to classify their period of ownership as justifying sale on a capital gain basis.

4. A markedly punitive feature of the bill as it passed the House is the definition of a "hobby farmer" which the bill states is open to rebuttal, the proof and expense of which would be high and the result doubtful. The penalties for being declared a "hobby farmer" are to have all costs for labor, feed, equipment, gasoline, oil, electricity, fertilizer, etc., disallowed for a five year period should the unfortunate cattle or horse breeder be forced into that definition by the new regulations and should he also have $50,000 a year non-farm or outside income.

Since the other portions of the House bill prevent such a "hobby farmer" from setting up any large farm loss to cover non-farm or outside income beyond a minimum figure, there does not seem to be much of a question of taxation or Federal revenue involved in this punitive provision, but rather a prejudice on the part of the Treasury Department against such citizens who seek to improve the quality of registered cattle or horses by incurring substantial losses in their production.

The penalties set up in the punitive provisions of this definition are so substantial that we believe that very few citizens with outside income will continue in the business of breeding registered cattle or registered horses.

We believe that the present excellence of American breeds of beef cattle and the large numbers of thoroughbred horses now produced are in large part due to the work and expenditures of breeders with other non-farm income.

We fail to see why the Treasury should object if their losses cannot by law serve as a cover for non-farm income.

This provision will be particularly destructive to most of the citizens who now breed thoroughbred horses and we respectfully suggest that thoroughbred racing is today an important part of the Maryland way of life, furnishes a substantial amount of State income, and will undoubtedly be severely dislocated should the definition of "hobby farmer" be enacted into law in the language in which it passed the House of Representatives.

(The committee subsequently received the following statement relative to the statement of Senator Mathias:)

STATEMENT OF PIERCE S. MCDONNELL, ESQUIRE, OF WARRENTON, VA., AND CLEVELAND HEIGHTS, OHIO

My name is Pierce S. McDonnell of Warrenton, Fauquier County, Virginia. I am a practicing lawyer, a Member of the Virginia Supreme Court of Appeals, and of the Bar of the United States Supreme Court.

Also, in regard to financial expertise as an economic expert, re certain non-Federal bond issues which are now exempt from Federal taxation under existing statutes, I have also been retained as a consultant.

After graduating from Case Western Reserve University, I completed my legal education at Yale; Graduate Business—Harvard; M.A. in Economics, Georgetown, and did my PhD work in Business Administration at Columbia University.

This morning I listened to the testimony and interrogation of the Honorable Charles McC. Mathias, Jr., of Maryland. My position is identical in many ways to the views presented by Senator Mathias with two major exceptions.

I. AGRICULTURE

He spoke of the importance of the cattle and horse industry in the State of Maryland. I wish to point out to your Committee the horse and cattle industry is very important to the Commonwealth of Virginia, particularly in Fauquier County. The quality of the breeding of our fine horses is known throughout the world sales market.

Farms owned and operated by Admiral Lewis L. Strauss, of Culpeper, and Judge Howard Smith, of Broad Run, are famous throughout the United States.

This witness urges your Committee not to destroy by the pending legislation before you what Virginians have worked so hard for so many generations to build up and operate with financial success under the free enterprise system.

May I strongly recommend that no changes be made in the existing law re capital gains from income from the sale of livestock.

2. BONDS

This section of my testimony deals with the proposed removal of the present tax exemption of non-Federal bonds issued by quasi-government and other political units below the state level as political subdivision thereof.

A. I oppose the provisions of H.R. 13270 for the same sound reasons as outlined by previous witnesses. The mere threat that the Congress may pass the pending provisions has depressed the bond market. It is now playing havoc with the traditional method that sales of certain Federal tax-exempt bonds, particularly state and municipal.

B. Other non-Federal tax bonds exempt from Federal taxation. In 1961 (privately distributed) and in 1964 I wrote a book entitled, "The Law of Turnpikes". Both were published by the National Academy of Sciences.

The statutes of 37 states provide that the bonds issued by these authorities shall be at fixed statutory rate and have been exempt like State and Municipal bonds from Federal taxation.

These business entities . . . turnpikes, toll bridges, etc. . . . are self-financed through the sale of revenue bonds. Senator Long's State had a successful pioneer program in this field; Senator Williams' State (in contact with Pennsylvania) also were early entrants in the program to build fine transportation facilities for the American public of the Eastern Seaboard area. All projects, in both these States, were financed by tax-exempt bonds.

As an individual who has been associated for over twenty years professionally in some of the problems raised by H.R. 13270, I believe that your Committee should not be politically maneuvered into a position where you will force another self-supporting industry into a financial jam where it will be almost practically unable . . . or absolutely unable . . . in terms of current bond sales conditions . . . to sell their low rate tax-exempt revenue bonds.

In closing, a word about the foundations proposals legislatively suggested by the Administration. I agree that the proposed tax on investment income be reduced to 2%.

Senator GORE. Thank you, Senator.

The committee will now hear from Mr. Dan Throop Smith.

STATEMENT OF DAN THROOP SMITH, PROFESSOR OF FINANCE EMERITUS, HARVARD UNIVERSITY, BOSTON, MASS.

Mr. SMITH. Thank you, Senator Gore.

I appreciate and welcome this opportunity to appear before the committee. For identification and for the record, I am Dan Throop Smith, professor emeritus, Harvard University, lecturer. Stanford University.

During the Eisenhower administration I was the Deputy Secretary of the Treasury for Tax Policy, past-president of the National Tax Association, the Tax Institute of America.

Needless to say, I speak only for myself. I think anyone familiar with professors know that they speak only for themselves.

I appreciate the fact that my prepared statement has been submitted in the record. I shall, even at the expense of being ungrammatical, highlight those few points which I particularly wish to express before this committee.

Because so many witnesses have come to object to provisions of the bill, I shall for about 2 minutes at the beginning, if I may, comment very favorably on provisions which I believe are major reform items which are long overdue in spite of the fact that many of them have been criticized by many other witnesses here.

I note specifically the Clay-Brown provisions, the extension of the unrelated business income tax to tax-exempt institutions not now subject to it, the extension of the provisions on farm losses and hobby losses. On that, if I may interject, I am referring to the extension of the limitation on losses, though on the basis of the discussion of the last 10 minutes, I recall well, back in 1953, being very much in the middle of the application of the rule regarding cash basis accounting for livestock growers which is now proposed to be changed by statute. I will be glad to comment on that if you so desire.

In general I am very much in favor of recapture provisions all the way across the board.

The extent of the tighter rules on multiple corporations, are again long overdue, as are recapture of depreciation on real estate, which is essential to justify realistic depreciation allowance on real estate, and the tighter rules on various peculiar forms of stock dividends, and separate classes of stock.

The Treasury has been moderately successful through regulation in stopping some of the things that can only be described as tax gimmicks, but it needs to be fortified by statute.

In general, I think the provisions with respect to mergers are also eminently desirable. The balance between the good and the bad of mergers is an extremely subtle one which I tried to spell out in my prepared statement. I particularly commend the provisions which will remove the opportunity to treat securities received in mergers as installment sales; the idea that those could be installment sales is really a travesty of the whole concept.

Now, turning to other points, and I shall again be very brief, on the tax-exempt bond provisions I feel that the proposal in the House bill with respect to future issues, to give the option to issuers to issue taxable or tax-exempt bonds with a Treasury payment related to interest if the choice is taxable, is a very good one.

It seems to me that on that basis there will not be a higher burden on the borrowers and the property owners and other taxpayers in the debtor communities.

The point of the proposal is that there will be a payment from the Federal Treasury to the borrowing governments, which will more than make up for the difference in interest cost.

As the markets have operated for the last generation, the savings to investors have vastly exceeded the savings from lower interest to the borrowers, and this proposal is a way to remove a tax differential from the capital markets with both levels of government, Federal, and State and local, being better off.

I think it is most unfortunate that the bill as passed in the House included tax-exempt interest in the so-called limitation on tax preference. I think that was bad in principle because it smacked of a retroactive treatment. It was, I suspect, a major unstablizing factor in the market, because it meant that some holders of present bonds would be disposed to unload them. That is in distinction to the provision for future issues of bonds.

I note that the Treasury has recommended that the limitation on tax preferences be removed from the bill, and I would merely urge that the sooner that can be done, the better, thereby removing the uncertainty that now hangs over the market.

Senator GORE. Mr. Smith, as I see it, the provision in the House bill neither solves the problem nor provides a satisfactory substitute for the communities. Interest would be taxed only through the L.T.P. It does not apply to the corporate holders of municipal bonds. It does not apply to trust holders. It does not apply in fact to even an individual holder unless that person has a majority of his income from a tax-exempt source. So it seems to me that this is particularly inadvisable. Its only result has been to thoroughly demoralize the market and raise a question as to the value of outstanding municipal, State and county securities.

Now you have suggested, as I understand it, that we not deal retroactively at all, that, beginning only with new issues the provision in the House bill apply, giving to the communities a choice of issuing tax-exempt securities or Government-subsidized securities. Is that a correct statement?

Mr. SMITH. You have stated my position better than I could, Senator Gore. That is precisely the point I make.

Senator GORE. That is the greatest compliment I have been paid in a long time. Thank you.

Could I ask you out of your learning to comment on a suggestion I advanced to people in my own State for consideration. I have not reached any conclusion as to whether it should be advanced legislatively, but taking into consideration the things which you have said. I suggest that we start now.

My father always taught me, "Son, always start from where you are," and here we are. Maybe we erroneously arrived at tax exemption but here we are, and I do not thing tax exemption can be withdrawn without some satisfactory substitute. I would hesitate to disrupt the market and the values of the present holders of municipal bonds.

I suggested, again beginning where we are, that we consider Government guarantee of State, county and municipal bonds with the payment by the Federal Government of one-half of the interest thereon on new issues. This came to my mind out of the experiences of government-owned corporations, who issued securities with Government guarantee. I notice that the rate, for instance, on TVA bonds is now only a fraction of a percentage point higher than that of the Government's bonds.

I do not know why it should be any larger.

Of course, the guarantee of such bonds could only be made on those local bonds which met local law, and which were not in contravention of Federal law. Now would you comment on that?

Mr. SMITH. It is certainly worth considerable study and exploration. I had not heard of it before precisely in that form, Senator Gore, so I am a little bit reluctant to give a categorical statement. My own feeling is that it is useful to start on fairly known steps, sure things, and then see if that is perhaps not enough. The proposal as you have stated it involves two things, the guarantee, and the payment of the Federal Government of part of the interest.

Now, the House bill with respect to future issues takes one of those, the partial payment of the interest, not your 50 percent figure, not a flat figure, but a sliding scale which would be more or less related to the market differential. This will be something which changes over the years. I think I would slightly prefer the sliding scale thing, not to have either a subsidy or a penalty vis-a-vis the Federal Government, and the States and localities on that.

On the guarantee feature, you state of course, that the bonds would have to be consistent with State law and not in contravention of Federal law.

I do not know precisely what concerns me but there is a little bit of an element of a blank check in that, as it is described. I believe that the partial interest payment will go so far on future issues, will go so far in dealing with the problem effectively, that I would be inclined to stop with that as a first step in the reform in this area. But yours is a very interesting point that I will certainly want to think about further.

Senator GORE. Thank you very much. I would appreciate any further thoughts you have on it.

Senator MILLER. Would my colleague permit a question on this particular point?

Senator GORE. Yes.

Senator MILLER. I am a little concerned about your statement that the proposed inclusion of tax exempt municipal bond interest in the limit on to tax preferences has an unsettling and disturbing impact on the municipal bond market.

As I understand the Treasury, at the end of 10 years this would amount to $35 million additional revenue, because the inclusion is phased in over a 10-year period. That would mean I would think that we are talking about $3½ million of impact, tax impact in the first year.

We have also received testimony from the Treasury that about $2 billion of tax exempt interest is paid out to individuals, and I must say that it taxes my imagination to believe that a proposed tax impact of $3½ million out of a $2 billion pay-out would have the unsettling effect on the market to which you refer. I can certainly understand the impact of the proposed ordinary income treatment to banks which are the primary customer, but I just cannot understand this impact of $3.5 million on $2 billion of income from this source on individuals.

Mr. SMITH. Two points, Senator Miller. First, I certainly did not mean to imply that this particular provision of the bill was the principal cause of the disturbances in the market. We have a great many disturbances. This is merely one additional factor.

My second point, I think, is that I believe the markets are very sensitive to symbols, to principles, if one likes, and since in the very way that Senator Gore indicated there is an element of retroactivity in the application of the limited tax preference to particular individuals who hold some of the bonds, if that willingness to breach what is a good faith acceptance of a present treatment is accepted by the full Congress, then I would suppose that a good many other high-bracket investors will say, "Let's unload before something worse happens."

Now this is a very subtle point. Your statistics certainly are absolutely right. It is a judgment factor.

Senator MILLER. You understand that this is the only way we can get at the situation where some people can have a large amount of income without paying any income tax at all?

Mr. SMITH. That is absolutely correct, but I have had occasion as a student and as a participant in government at one time or another to be involved in various approaches to this tax-exempt-bond interest problem over generations, and my impression is that every time there has been a really serious or useful approach, it has lost, I believe, because it has gone too far. I of course from the outside have no idea what is likely to come out of this, but when the proposal first came, when I first saw it in the House bill, and I saw the two parts, I said wonderful for the future, and then I wondered to myself is the thing in some way being jeopardized? Is this basic reform being jeopardized by trying to go a little bit too far in getting what is in effect a retroactive application?

Senator MILLER. Well, then, in view of that would you favor the LTP approach with respect to prospective issues?

Senator GORE. With respect to what?

Mr. SMITH. Prospective issues.

Senator MILLER. Prospective issues, yes. That would obviate the concern. Let everybody buy knowing the results of the game and do not change them in retrospect.

Senator BENNETT. Mr. Chairman, I hate to be the so-and-so on this committee. We have got 13 more witnesses. We have taken an hour and we have just started on our third witness.

Senator GORE. Senator Bennett, you ——

Senator BENNETT. You will remember the chairman's proposal that if we wanted to talk details with the witness, we had the privilege of going into the back room and continuing the discussion.

Senator GORE. Well, this is true, but this man is very learned, very experienced in this field, and the purpose of this hearing as long as I am here is to inform the committee, and this man is full of information.

Senator BENNETT. The back room is full of opportunity, and a stenographer.

Senator GORE. I will violate the rule once more if I may. Just to respond to Senator Miller about the effect of the House bill on the market. I think there are two things. One is precedent, overwhelming passage of the bill taxing in part income from so-called tax-exempt securities.

Second, once the principle is established retroactively what justification is there to applying it only to individuals? What about banks? Vaults are full of tax-exempt securities. I see no justification for exempting the banks and taxing individuals.

Rather than solving the problem, or even dealing with it meaningfully, the result of the House bill in this regard has been to thoroughly upset the present situation. Now this does not mean, as I see it, that we should abandon search for solution. I think we need to seek a solution. I will not interrupt any further.

Mr. SMITH. I shall proceed as rapidly as I can, even without using full sentences.

As regards private foundations, the provisions with respect to self-dealing seem reasonable and good. Provisions with respect to the use of assets are in the same category.

The so-called tax on investment income again seems to introduce a principle which would be unfortunate. The Treasury's proposal that there be a charge related to the cost of policing was eminently desirable, and I trust will be adopted. I have heard suggestions even that that might better be referred to as an excise than an income tax, and that to my layman's point of view makes sense also.

The point which is of great public concern with respect to foundations is what seems to many of us to be too tight a rule on this so-called influencing legislation. The provisions of the House bill, as they stand, would seem in a variety of ways, for instance, to prevent grants for such things as antipollution control, the population problem and the like.

There has been much staff study I know. There have been many discussions, many witnesses. It seems there is a fair prospect of developing language which will prevent the abuses of participating in particular elections, voter registration drives and the like but not having the great restrictions that the House bill has. The language of the House bill would be so restrictive I think that it would be little less than tragic if that were adopted.

With respect to restricted properties, that is restricted stock options, yes, one might say, why not put it in, but really why bother to put it in, because with the 50 percent maximum rate on earned income which I shall refer to later, the advantages of stock options of all sorts will be so much reduced that this whole area will probably wither away in importance.

On deferred compensation I have somewhat the same feeling. With a reasonable ceiling and the maximum rate, the advantages of deferral will not be sufficiently great to make it important.

I do note further with respect to deferred income, that there are very difficult problems of definition, and to adopt the House provisions will inevitably open up a great deal of litigation and uncertainty in the law.

With respect to percentage depletion on foreign oil production, as the report of the House committee indicates this will not bring in any revenue to the Treasury. In the long run in effect what will happen will be that other countries will raise their taxes and U.S. companies will be at a tax disadvantage, not for the benefit of the U.S. Treasury but for the benefit of foreign treasuries.

I would very much hope that that would be dropped.

With respect to capital gains, a general tightening in the definitions and concepts is long overdue, but I take the liberty of reading three sentences if I may from my prepared statement. This has to do with the general treatment and concept of capital gains.

Though the so-called net accretion concept of income is popular in much of the theoretical writing on public finance the distinction between capital and income is basic in corporate accounting and law, in trust law and indeed in family management.

A family, a corporation or a trustee which is so imprudent as to fail to recognize this distinction is headed for trouble. A government which fails to recognize the distinction and by its tax law encourages its citizens to disregard the distinction seems imprudent to a high degree.

I do believe there is a profound difference between capital gains and ordinary income, and for that reason I think it is most unfortunate that the alternative tax rate is being dropped. But it would seem to me vastly better to go back to what was in the law in the 1930's for a few years and that is to have a sliding scale for the inclusion of capital gains. Specifically I suggest up to 1 year full inclusion, 1 to 2 years 75 percent, 2 to 5, 50 percent, over 10 years, 20 percent.

In that case there would of course not be a need for an alternative tax rate on capital gains.

I have always felt with the 6 months holding period, that it was unreasonably short, that it jeopardizes the whole concept of capital gains. I support the provision of the House bill to extend the holding period to 1 year.

I note that the Treasury has proposed that it go back to 6 months, but I do not agree in that respect. There may, however, be a matter of appropriate timing for this change.

With respect to charitable contributions, the matter of appraisal on art objects has been the subject of so much abuse it has become really a tax gimmick. I thought the House bill was wise in including the limitation of the charitable deduction to cost.

I note the Treasury has proposed that that be modified by going back to market value. In principle I think market value is right, but this is an area where the law is in a sense coming into disrepute because of the abuses that have been engaged in by some individuals.

So I felt that the limitation to cost was a reasonable one, so long as it is not an entering wedge to applying that rule to all forms of gifts.

The principal damage from the proposed changes regarding charitable contributions, however, comes from the attempt to include in the limitation on tax preferences in the allocation of deductions the appreciation, the unrealized appreciation, on contributed property. I note that the Treasury has proposed that that be dropped from both the limitation on tax preferences and allocation of deductions. My statement indicates the reasons why, I think that is particularly important and I cannot overemphasize it. This recommendation of the Treasury is extremely important for universities, and here I will speak as the vice chairman of the trustees of a small middle western college, Iowa Wesleyan.

We are all concerned, those of us in education very much concerned, that the flow of major gifts not be interrupted. The Treasury recommendation for modifying the House provision is extremely important in this sense. The House bill would have tragic consequences.

I have comments on the accumulation trusts which are in the record. I shall not take the committee's time on that.

The investment credit should never have been put in. It might as well go out. But there had better be, in my opinion, more liberal depreciation in a variety of ways.

I would like to comment, however, on the special amortization of pollution control facilities. Special amortization may be justified because of the overwhelming importance of the subject, that is pollution control, but this is both an inadequate and incorrect solution to the problem. Severe fines and other penalties are necessary and appropriate. When costs are imposed on society by industrial processes which pollute the environment, those costs should be thrown back on the producers and, in the last analysis, borne by the consumers of those products rather than absorbed by society generally.

Special tax treatment in a sense shifts to other taxpayers part of the costs which should be borne by the industry and its consumers.

Let us not think that special amortization for pollution facilities is going to solve this problem. I think it is a poor way to get at it, but it needs much more severe treatment than it has here.

Now in conclusion on the general balance of the bill, and that is the general subject for today, I should like to make a few points. I have tried to choose my words as carefully as I can to be effective and will ask for the liberty of reading something that will take not over 3 minutes. Though many, probably most of the substantive changes are desirable on their merits, any major tax legislation must be appraised on its overall balance.

On this basis H.R. 13270 seems seriously deficient as dramatically shown in tables 3 and 6 in Secretary Kennedy's presentation to your committee on September 4.

A reduction in individual tax burdens of $7.3 billion, and an increase in the corporate tax burden of $4.9 billion, does not seem wise in a country which needs continuing new investment in order to increase labor productivity, and thereby make wage increases somewhat less inflationary than they have been, to strengthen our position in international competition, and help to provide funds to finance the innovations which are essential to maintain the vitality of our economy.

The distribution of tax burdens between individuals and business unfortunately may come to have political overtones. It should always be remembered that the Kennedy administration—I refer to President Kennedy, not Secretary Kennedy—the Kennedy administration in its first set of tax recommendations in 1961 proposed relief solely, and I emphasize solely, to encourage investment through the investment credit.

Though many of us regretted that particular form of tax relief, preferring as we did more liberal depreciation, the wisdom of recognizing that investment is important along with consumption was notable, especially when it was shown in an administration which might have been presumed on political grounds to favor consumption.

The present lack of balance involving as it does an actual increase in taxes on the principal sources of funds for investment and on the returns from investment is a sorry contrast indeed. It will be unfortunate if circumstances prevent the adoption of a better balance in this first tax legislation of new administration in the present Congress.

The adoption of a maximum marginal rate of 50 percent on earned income is probably the most important single change which could be made to reduce the continued search for new tax loopholes and restore an atmosphere conducive to truly productive work.

The 50-percent figure is particularly important. It has a symbolic significance in terms of an even break, or 50–50 partnership, in the taxpayer's relationship to his government. It is unfortunate that a similar maximum was not set up for all income. In view of the probable redirection of efforts and removal of constraints any revenue estimate of these changes is conjectural. The 50-percent maximum may, in fact, increase revenue. Without the 50-percent ceiling on the marginal rate of tax on earned income, H.R. 13270 would be even more seriously unbalanced.

The reasons for the 50-percent ceiling are spendidly stated in the report of the House Committee on Ways and Means. The same arguments apply to investment income as well. A general top marginal rate of 50 percent would cleanse the tax atmosphere more thoroughly than any other feature of tax reform legislation.

The net effect of the bill will be to make the tax system much more progressive than it is now, even with the 50-percent ceiling. This result is shown conspicuously in table 3 of Secretary Kennedy's statement of September 4. The percentage of the relief descends steadily from the smaller to the larger incomes thereby shifting the burden to the larger incomes. And in the top bracket shown in the table, incomes over $100,000, there is an actual increase of 4.7 percent in total taxes.

Though most of us have a quasi-intuitive acceptance of progressive taxation as fair, progression can be pushed too far and an absolute increase in taxes at the top when individuals generally are being given over $7 billions of relief seems unfair. Only the 50-percent ceiling on earned income makes it acceptable without deep resentment.

One final point cannot be ignored in connection with any legislation making extensive changes in the individual income tax. I have saved it for the last for emphasis. The tax law has thus far included no provision relevant to the world's greatest social and economic problem—the overwhelming expansion of the population.

Uncontrolled population growth has finally been recognized as leading to the doom of civilization as we know it—even to the doom of mankind.

I call your attention to the New York Times today. Almost every day we are getting wonderful momentum in approaches to this problem. Though the tax law may now be one of the least effective ways to attempt to deal with this problem, one change could be made to dramatize its importance and in a small way reinforce the more significant approaches. Reductions for dependent children should be limited to two at a high enough income level to prevent hardship for larger families now in existence.

The choice of the income level is not important. It might be $15,000 or $50,000. The important thing is to set a standard and symbolically help to refute the strange claims by some opponents of population control that it represents selective genocide or counterinsurgency. This is probably the first time testimony on tax legislation by a tax specialist has included reference to the population problem. I am sure it will not be the last. I would welcome an opportunity to develop the subject at length.

Thank you very much, Senator Gore, for the opportunity to appear before the committee.

Senator GORE. Thank you very much.

Senator HANSEN. May I ask one question, Mr. Chairman? In your testimony, you say the special amortization of pollution control facilities may be justified because of the overwhelming importance of the subject, but that this is both an inadequate and incorrect solution to the problem.

Mr. SMITH. Yes.

Senator HANSEN. Would I infer from this that if there is a thermal pollution problem in connection with the generation of electrical energy, it would be your recommendation that the cost of pollution abatement machinery should properly be borne by raising the cost of electrical energy to the consumer, rather than to subsidize it by the Government?

Mr. SMITH. That is precisely my point, Senator.

Senator HANSEN. Thank you, Mr. Chairman.

Senator MILLER. May I ask a question, Mr. Chairman?.

Do I understand that you endorse the House bill provisions regarding the nondeductibility of interest in certain corporate applications?

Mr. SMITH. I do, sir.

Senator MILLER. The thing that troubles me about it is that I thought a very good point was made the other day by one of the witnesses when he said What is the difference between using this debt approach or equity approach in external expansion as against internal expansion? What is the difference if one corporation, not a very large one, uses that approach to acquire another relatively small corporation, and a very large corporation uses this approach to take on some assets for internal expansion? It seems to me that what we ought to be doing here is we ought to be drawing some guidelines between debt and equity across the board, and we do not do that.

Mr. SMITH. I think this is certainly a temporizing action, Senator. I quite agree that the law is illogical in the distinctions that it does make between debts and equity. There are some very fundamental reforms that need to be made in that respect.

My concern about mergers, and in my fuller text I elaborate on this, is that some of the forms of acquisitions have brought to the forefront a wheeler-dealer type of activity in the country, which is in my opinion confirming the worst but unjustified suspicions of many of the young people that the whole business system is made up of wheeler-dealers.

Now, this is a strange thing to bring into the tax law you may say, but I am very much in touch with young people in two universities, and when they see in many instances where acquisitions involve capital structures to which the new debt, the interest charges on the new debt exceeds the before-tax income of the company being acquired, as has been done sometimes, they think that business consists of shenanigans rather than really being constructive.

I develop this at some length in my testimony. I feel that there have been two things wrong. One, abuses in the forms of acquisitions, predatory rather than constructive, and many mergers are constructive but many of them also are predatory, and secondly that the capital structures of some of these companies are, as I say, unduly reminiscent of the sort of capital structure that we had in the late 1920's, the inverted pyramid-type thing.

So I think it is time for the tax law to try to help and call a halt until we can work out a better approach.

Senator MILLER. I share your concern about the attitude of young people and I share your concern about wheeler-dealer situations, but I must say that it seems to me that that concern ought to be placed over in the Antitrust Division of the Department of Justice, and over in the Securities and Exchange Commission, or in the appropriate committees here on Capitol Hill, rather than to single out this one particular area for the concern of the Finance Committee.

Now if we were going to draw a line across the board setting a guideline between equity and debt capital that is something else, but I do have a reluctance for us to start getting into the other department's business. Certainly I think you would agree that they should be on top of this, too?

Mr. SMITH. I quite agree and I am in a strange position because I have so often urged when I was in the Government that we should stick to revenue matters, but this is to me an overwhelmingly important topic.

Senator MILLER. Thank you. It is always good to see you, Mr. Smith.

Mr. SMITH. Thank you, Senator.

Senator GORE. Thank you very much.

(Mr. Smith's prepared statement follows:)

STATEMENT OF DAN THROOP SMITH

Mr. Chairman and Members of the Senate Committee on Finance, it is a pleasure and honor to have this opportunity to appear before you with reference to H.R. 13270 which would make the most extensive revisions in the tax laws since the adoption of the Internal Revenue Code of 1954. Many of the substantive revisions are long overdue. They will prevent abuses which have developed under the letter of the existing law but seem rather clearly to flout its spirit and the intent of the Congress. In that category, one may readily include the Clay-Brown provisions and the extension of the unrelated business income tax to the exempt organizations to which it does not yet apply; the tighter rules on farm and hobby losses; the prevention of tax benefits through a proliferation of multiple corporations; the tighter rules for taxation of cooperatives: the recapture of depreciation on real estate; the rules for peculiar forms of stock dividends and separate classes of common stock and the proposed limitations on certain aspects of mergers, which are discussed subsequently. The reasons for the foregoing changes are all well stated in the Report of the House Committee on Ways and Means.

Other substantive provisions represent new departures, some of which seem unduly complicated and questionable from the standpoint of economic or social policy.

STATE AND MUNICIPAL BOND INTEREST

The proposal for an option to states and localities to issue taxable bonds, with a Federal Interest subsidy which would more than offset the higher interest costs is the best approach thus far devised to deal with a problem which each year becomes more perverse in its effects. The issues of state and local bonds have become so large that they can be absorbed only by offering yields which do not reflect their tax advantage to most holders. The interest savings to borrowers are far less than the revenue losses to the Federal government; under the proposed new procedure both levels of government would be better off, a distorting element in the flow of investment funds would be removed and the highest-bracket taxpayers would no longer have an opportunity for a large intramarginal tax benefit.

But any change in the treatment of municipal taxes should be made only with respect to future issues. The inclusion of municipal bond interest in the limit on tax preferences would be a form of retroactive legislation. And it has already disturbed the bond market. The Treasury recommendation to remove this item from the limitation on tax preferences should be accepted—and the sooner the better for our hard-pressed state and local governments.

PRIVATE FOUNDATIONS

As regards private foundations, the prohibitions on self-dealing seem thoroughly reasonable and desirable. There have been significant abuses and the proposed constraints would not appear to hamper any reasonable objectives of foundations. The same statement seems valid with respect to the limitation on stock ownership and the use of assets, through a long period should be allowed for divestment. It should also be recognized that in a good many cases companies in which foundations hold a large interest will become vulnerable to raids by other corporations seeking mergers.

The imposition of a tax on investment income, by contrast, seems to be an undesirable and uncalled for penalty. Tax-exempt charitable and educational organizations have been a source of real strength in our society and their continued activity will help to maintain diversity in areas where there is danger of excessive uniformity through expanded government programs. Once adopted, the applicable tax rate is likely to be increased as a response to unpopular programs financed by one or a few foundations, thereby depleting the strength of all foundations. It would be much more desirable to impose necessary restrictions directly as is done in other parts of the applicable sections and to confine any tax to a fee sufficient to cover the costs of administering returns of tax-exempt foundations as has been proposed by the Treasury.

Furthermore the line of demarcation between permitted and forbidden activities concerning legislation is too vague and would almost certainly prevent outlays on such important subjects as the population explosion and the prevention of further pollution of the environment. Some constraints are necessary, especially those related to expenditures for a particular candidate or selective voter registration, but revision in the statutory language or some very strong and clear examples of exemptions in the Committee Reports seem necessary if the country is not to lose the benefit of leadership of foundations in dealing with social problems which almost inevitably involve legislation of one sort or another. Specifically, the prohibition of expenditures "to carry out propaganda, or otherwise attempt to influence legislation" in section 4945(b)(1), described further as "any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof" in section 4945(c) is much too comprehensive. I repeat for emphasis that programs to alert the general public to the problems of the population explosion and the pollution of our environment would appear to be ruled out. Governments have been very slow to develop their own programs in these two most vital areas; society needs all the leadership and education it can get on subjects such as these, and tax legislation which prevents bold action would be little short of tragic.

RESTRICTED PROPERTY

Options in restricted stock will probably not be used to any appreciable extent in the future if the proposed changes in their tax treatment are adopted. Options in this type of stock have developed in recent years to circumvent some of the limitations imposed on qualified stock options which are given special favorable treatment in the tax law. Since options in restricted stock may be used to secure more favorable tax treatment, it is not unreasonable that their value should be taxed fully as ordinary income.

Though the subject of options is controversial, there is a good deal to be said for long-term stock ownership by management in the companies for which they are responsible. Unfortunately, stock options have too frequently been abused, with quick sales as soon as stock qualifies for capital gains treatment. The present law on qualified stock options might well require a longer holding period and permit a longer period for options to run before exercise.

But the maximum marginal tax rate of 50 percent on earned income will significantly change the relative attraction of options and cash compensation for both executives and corporations in favor of cash compensation. The use of options of all sorts will probably decrease in any case, and the new provisions on options in restricted stock will turn out to be relatively unimportant.

DEFERRED COMPENSATION

The 50 percent maximum marginal rate on earned income will also very substantially reduce the advantages of deferred compensation contracts. The difference in the tax rate applicable to pre-retirement and post-retirement income will be much less for executives with large salaries, and they will tend to find that the advantage of immediate receipt of income, with opportunities for immediate investment, will outweigh the advantages of postponed receipt for relatively minor tax differentials. Thus the use of deferred compensation contracts may be expected to diminish considerably.

One of the reasons for the existing revenue ruling in 1960 was to remove an annoying area of uncertainty in the tax law. There are many ways to write compensation contracts to make income payments after normal retirement appear to be related to continuing advisory services. Extensive litigation occurred and skilled tax practitioners were usually able to construct a contract which ostensibly related later payments to later years. The proposed legislation would throw into the courts again this whole subject with an advantage given to those who sought the advice of specialists. In view of the probably substantial reduction in the use of deferred compensation contracts, it seems doubtful that it would be worthwhile to recreate this area of uncertainty.

When the revenue ruling was adopted in 1960, it was feared that large established companies whose credit was unquestioned might have an unfair tax advantage over small or new companies with which a defined compensation contract would be of questionable value. There is no evidence that the ruling has had this effect and the only issue thus has become one of equity which, as noted above, will be minimal in the future. Certainly would seem to be more important than a minor refinement of equity. The Treasury recommendation to postpone action in this area is reasonable.

If legislation is adopted now, it would appear to be unreasonable to exclude deferred compensation from earned income to which the 50 per cent maximum marginal rate applies. Though compensation is deferred it is still compensation and should be treated like all other forms of earned income.

PERCENTAGE DEPLETION OF FOREIGN PRODUCTION

As the House Committee Report indicates, any revenue gain from the repeal of foreign percentage depletion will be eliminated in the long run by increased foreign taxes. This change in the law is thus not only pointless but actually perverse in its effects. The profits of U.S. companies will be reduced by higher foreign taxes. Our balance of payments will be hurt because there will be smaller foreign profits to be repatriated. And to the extent that foreign countries impose higher taxes selectively on U.S. companies, American oil companies will be at a competitive disadvantage in comparison with corporations of other countries. In view of the importance of income from foreign oil operations for our balance of payments, it seems contrary to our national interest to invite other countries to put U.S. companies at a tax disadvantage. The Treasury has wisely recommended that this provision be dropped.

CAPITAL GAINS AND LOSSES

Though the tigher definitions of capital gains are generally reasonable, the removal of the 25 per cent maximum rate under the alternative tax is undesirable and, in the minds of many people, unfair. The U.S. tax law has recognized the special status of capital gains for almost 50 years. Though the net accretion concept of income is popular in much of the theoretical writing in public finance, the distinction between capital and income is basic in corporate accounting and law, in trust law and indeed in family financial management. A family, a corporation, or a trustee which is so imprudent as to fail to recognize this distinction is headed for trouble. A government which fails to recognize the distinction, and by its tax laws encourages its citizens to disregard the distinction, seems imprudent to a high degree.

The economic and equity arguments regarding the taxation of capital gains are all familiar and need not be repeated here. The 25 per cent maximum has been in the law for many years and it seems quite inappropriate to single out this one rate for such substantial increase to 35 percent for those in the top bracket (and higher if one takes account of the surcharge). In fact, to put this rate up by 10 percentage points while reducing the maximum rate by only 5 percentage points seems extremely unfair in a bill which purports to give general relief to all income levels.

It should be noted further that the realization of a capital gain is an indefinitely postponable act. Though there is no magic in the 25 per cent maximum, a large increase in the rate may so reduce transactions that it will actually reduce both revenue and mobility of capital funds.

The extension of the holding period from six months to a year to qualify for long-term capital gains treatment is appropriate; gains on short-term holdings may be expected to represent trading profits regarded as available for consumption rather than true capital appreciation embodied in an individual's capital fund. The longer holding period will probably reduce total transactions in the security markets, but it is questionable whether rapid turnover does not represent mere churning in the markets with little benefit with regard to mobilization of savings or corporate financing.

However, the extension of the holding period suggests the reintroduction of a series of steps for percentage of inclusion of capital gains. This seems reasonable both from the standpoint of equity and economic policy. As a matter of equity, the longer-term gains are more likely to be regarded as a part of one's capital, and a tax on a shift in the particular investments held thus becomes a capital levy rather than a tax on income. From the standpoint of economic effects, as noted above, short-term gains represent trading activity rather than investment, and though a certain amount of trading is necessary to assure liquidity in the market, excessive trading may involve mere churning and even lead to greater fluctuations in security prices which on balance will repel rather than induce investment.

Specifically, I urge that consideration be given to a sliding scale with a range of percentage inclusions such as:

Up to 1 year	Full inclusion.
1 to 2 years	75 percent.
2 to 5 years	50 percent.
5 to 10 years	30 percent.
Over 10 years	20 percent.

With a sliding scale such as this, there would of course be no need for an alternative tax to keep a reasonable maximum rate on those capital gains which are most likely to be the capital gains in which the proceeds, net of tax, are kept embodied in capital investments.

CHARITABLE CONTRIBUTIONS

Some aspects of the proposed change in the treatment of charitable contributions of appreciated property seem reasonable to prevent artificially high deductions. Apparently there has been a good deal of abuse in claims of high values for art objects, with recipient museums and galleries having no adverse interest against excessive valuations. In spite of the Treasury's statement that the abuse has been brought under control by new administrative procedures, a limitation of the charitable contribution for art objects to cost would not be unreasonable nor should it, in the long run, prevent ultimate gifts to museums. Ownership by successive generations would be likely to be prevented by estate taxes.

However, this should be the only exception to the general rule of charitable deductions measured by value, without any general attempt to tax appreciation directly or indirectly. The Treasury's recommendation to remove the appreciation on contributed property from the limit on tax preferences and the allocation of deductions was most welcome. If this is not done, many educational institutions and hospitals will be badly hurt in their drive for funds. There is little if any room for abuse through artificially high valuations in gifts of securities. The pattern of private gifts for education and charities is so important to maintain our pluralistic society that the tax laws should not be changed to curtail them.

ACCUMULATION TRUSTS

The proposed new rules on accumulation trusts are exceedingly complicated. Secretary Cohen's merciful and wise recommendation that they be made to apply prospectively should be adopted to avoid the imposition of a really impossible task of reconstructing for past years the income of young people for whom no income records were kept because it was known that they would have no tax to pay. Even when applied prospectively, the task is a formidable one. To assure an accurate tax on termination of a trust, records will have to be kept for even a few dollars of income for every infant who may turn out to be the beneficiary of a trust which has accumulated income.

On various occasions, I have proposed a change in the law to deal with abuses under accumulation trusts which I believe would be both tighter and simpler than the present proposal. The alternative approach would tax income of an inter vivos trust to the grantor unless it was distributed and taxed to a living beneficiary and require the consolidation of income from all testamentary trusts and inter vivos trusts after the death of the grantor. If the proposed change in H.R. 13270 is adopted, it would seem reasonable to make it apply only to accumulations after the beneficiary has come of age by which time a young person may be expected to keep adequate income records anyway. There are many trusts established by grandparents for grandchildren with no thought of tax avoidance.

In 1954, when this Committee approved new rules permitting double personal exemptions for dependent children and their parents, one of the reasons was to prevent young people from discovering that the income tax law was irrational and perverse in its effects at the time of their first personal contact with it. The new rule on accumulation trusts, unless modified to apply only to accumulations after a beneficiary comes of age, is likely to become a horrifying example of complexity and destroy respect for the tax law, which is the mainstay of our revenue system, on the part of another generation of young people.

INVESTMENT CREDIT AND AMORTIZATION

The investment credit should never have been adopted and its repeal is no loss. But at the same time the reserve ratio test in the use of the depreciation guidelines should be removed by administrative action or, if that is not deemed possible, by statutory authorization. This test will place severe limitations on the use of the guidelines in the future. No other major industrial country has any similar constraints. If it is continued, the United States tax law will put U.S. business at a significant disadvantage compared to foreign competition in maintaining modern plant and equipment which is essential to increase productivity and thereby justify noninflationary wage raises, increase the real national income and strengthen our balance of payments.

The special amortization of pollution control facilities may be justified because of the overwhelming importance of the subject. But this is both an inadequate and incorrect solution to the problem. Severe fines and other penalties are necessary and appropriate. When costs are imposed on society by industrial processes which pollute the environment, those costs should be thrown back on the producers, and in the last analysis borne by the consumers of those products (or products produced by those processes), rather than absorbed by society generally. Special tax treatment in a sense shifts to other taxpayers part of the costs which should be borne by the industry and its consumers.

CORPORATE MERGERS

A balanced judgment on the economic significance of mergers, especially the recent rapid increase of conglomerate mergers, cannot now be made. A great deal more study is necessary, and only with the passage of time can we accumulate evidence on the effects of the new large and virtually random types of acquisitions.

In many instances mergers may strengthen individual firms and increase their competitive effectiveness. New management may be provided to a small or family-dominated company and additional financing made available to a company which is too weak or too small to tap capital markets economically. Centralized staff services may permit an innovative manager to pursue ideas without being bogged down in administrative work for which he has little taste or talent. Well matched companies and individuals may develop new strengths from their complementary attributes. And the threat of a merger through a take-over may scare a lethargic management into activity.

But mergers may also reduce competition. They may lead to a dominance by financial manipulators instead of truly constructive managers. The threat of raids may divert attention from long-run growth to defensive actions. New ownership under a holding company may repel innovators and lead to a substitution of unimaginative organization men. And the capital structures of some of the new conglomerates are uncomfortably reminiscent of some of the holding company inverted pyramids of the late 1920's. When the fixed charges on new securities issued in acquisitions exceed the pre-tax income of the companies acquired it seems likely that leverage is being pushed too far, and that a tax law which discriminates against equity financing is leading to unstable financial structures.

Perhaps the most serious result of the conglomerate merger movement is the prominence it gives to the wheeler-dealer type of entrepreneur whose well-publicized manipulations confirm the worst suspicions of the many young people who are disposed to regard the business establishment as predatory. Though there are numerous thoroughly constructive individuals in merger activity, there are a considerable number who would in fact be regarded as at best neutral, and at the worst, truly predatory under most people's standards, including the majority of business executives. The disenchantment of young people with our present economic structure is so widespread that society can ill afford to permit continuation of an aspect of business which, even though it may be minor and unrepresentative, is so prominent and distasteful to many people that it strengthens their disposition to reject the entire system.

In the absence of detailed studies on mergers, it is difficult to be sure of the soundness of the specific changes in the tax law contained in the bill. They seem reasonable, however, and if anything perhaps too lenient rather than too stringent. Certainly the denial of the installment sale provisions to sales of companies in return for securities is necessary to protect the legitimacy of the concept. The very idea that such transactions could qualify as installment sales was a travesty of the principle.

GENERAL COMMENTS ON BALANCE OF PROVISIONS IN H.R. 13270

Though many, probably most, of the substantive changes are desirable on their merits, any major tax legislation must be appraised on its over-all balance. On this basis, H.R. 13270 seems seriously deficient, as dramatically shown in Tables 3 and 6 in Secretary Kennedy's presentation to your Committee on September 4. A reduction in individual tax burdens of $7.3 billions and an increase in the corporate tax burden of $4.9 billion does not seem wise in a country which needs continuing new investment in order to increase labor productivity (and thereby make wage increases somewhat less inflationary than they have been), to strengthen our position in international competition, and help to provide funds to finance the innovations which are essential to maintain the vitality of our economy.

The distribution of tax burdens between individuals and business unfortunately may come to have political overtones. It should always be remembered that the Kennedy Administration in its first set of tax recommendations in 1961 proposed relief solely—and I emphasize *solely*—to encourage investment through the investment credit. Though many of us regretted that particular form of tax relief, preferring, as we did, more liberal depreciation, the wisdom of recognizing that investment is important along with consumption was notable especially when it was shown in an Administration which might have been presumed on political grounds to favor consumption. The present lack of balance, involving as it does an actual increase in taxes on the principal sources of funds for investment and on the returns from investment, is a sorry contrast indeed. It will be unfortunate if circumstances prevent the adoption of a better balance in this first tax legislation of the new Administration and the present Congress.

The adoption of a maximum marginal rate of 50% on earned income is probably the most important single change which could be made to reduce the continued search for new tax loopholes and restore an atmosphere conducive to truly productive work. The 50 per cent figure is particularly important; it has a symbolic significance in terms of an "even-break" or "50–50 partnership" in the taxpayer's relationship to his government. It is unfortunate that a similar maximum has not been set up for all income. In view of the probable redirection of efforts and removal of constraints, any revenue estimate of these changes is conjectural. The 50 per cent maximum rate may, in fact, increase revenue. Without the 50 per cent ceiling on the marginal rate of tax on earned income, H.R. 13270 would be even more seriously unbalanced.

The reasons for the 50 per cent ceiling are splendidly stated in the Report of the House Committee on Ways and Means. The same arguments apply to investment income as well. A general top marginal rate of 50 per cent would cleanse the tax atmosphere more thoroughly than any other feature of tax reform legislation.

The net effect of the bill will be to make the tax system much more progressive than it is now, even with the 50 per cent ceiling. This result is shown conspicuously in Table 3 of Secretary Kennedy's statement of September 4. The percentage of tax relief descends steadily from the smaller to the larger incomes thereby shifting the burden to the larger incomes. And in the top bracket shown in the Table, incomes over $100,000 there is an actual increase of 4.7 per cent in total taxes! Though most of us have a quasi-intuitive acceptance of progressive taxation as fair, progression can be pushed too far and an absolute increase in taxes at the top when individuals generally are being given over $7 billions of relief seems unfair. Only the 50 per cent ceiling on earned income makes it acceptable without deep resentment.

One final point cannot be ignored in connection with any legislation making extensive changes in the individual income tax. I have saved it for the last for emphasis. The tax law has thus far included no provision relevant to the world's greatest social and economic problem—the overwhelming expansion of the population. Uncontrolled population growth has finally been recognized as leading to the doom of civilization as we know it—even to the doom of mankind. Though the tax law may now be one of the least effective ways to attempt to deal with this problem, one change could be made to dramatize its importance and in a small way reinforce other more significant approaches. Deductions for dependent children should be limited to two at a high enough income level to prevent hardship for larger families now in existence. The choice of the income level is not important. It might be $15,000 or $50,000. The important thing is to set a standard and symbolically help to refute the strange claims by some opponents of population control that it represents selective genocide or counter-insurgency. This is probably the first time testimony on tax legislation by a tax specialist has included reference to the population problem. I am sure it will not be the last. I would welcome an opportunity to develop the subject at length.

Senator Gore. The committee will next hear Mr. George S. Koch. Mr. Koch, we will be glad to hear from you at this time, sir.

STATEMENT OF GEORGE S. KOCH, CHAIRMAN OF THE FEDERAL FINANCE COMMITTEE, COUNCIL OF STATE CHAMBERS OF COMMERCE; ACCOMPANIED BY EUGENE F. RINTA, EXECUTIVE DIRECTOR OF THE COUNCIL

Mr. Koch. We have submitted material to you as you can see from the printed booklet. We have summary pages to begin with, but my oral statement, which is designed to take no more than our allotted time, appears at the beginning of our statement after the summary.

My name is George S. Koch. I am a practicing attorney in New York, and am chairman of the Federal Finance Committee of the Council of State Chambers of Commerce.

Mr. Eugene F. Rinta is the executive director of the council, and he is here with me.

We represent 31 State chambers of commerce within our council. They are listed in my prepared statement.

Our statement actually includes only 24 endorsements. Our principal problems was one of timing, because these chambers have their boards of directors and other controlling bodies which had to consider the views in the statement. Our statement was prepared and sent to them, but by the time it went through this process, we were simply unable to get the other commitments.

We are a group of business and chambers of commerce representatives who deal with Federal finance and taxes, and we believe we have a good basis for our opinions on these matters. As you can see from our paper, we frankly do not like the bill.

I think in general we should say that it is oriented against business, it is oriented against capital formation, and it is oriented against investment. We feel that under our capitalistic system this is the wrong direction to take. As a matter of fact, I think the council's position over the years has simply been that we should improve the situation rather than be regressive.

Now the bill in a sense is regressive in a number of ways, since it changes so many things adversely to the economy, and it is regressive especially in respect to its retroactivity.

We met on the 11th and 12th of September as a committee to formulate our views, and it was my experience that our membership has never been so dismayed or unhappy or thought we had a wrong situation as in this tax bill. This was a unanimous opinion.

Another position coming from this group was simply that there are too many proposals in that bill which are not improvements in the true sense. and consequently we feel should be rejected.

In our time a new principle has emerged. It is that high income taxation is so vital a consideration of business and individual decisions that its application must be understood and be predictable. For instance, take a look at what has happened to the State municipal bond market, and the confusion that exists with respect to the proposed repeal of the 7 percent investment credit.

Now, of course, Congress can change the tax law. That is certainly axiomatic. But it seems that such changes must be tempered by what is best for the Nation as well as by an awareness of and adherence to the rules of the game, and this requires a thorough understanding of how the changes will work. This bill certainly fails to meet these principles in our opinion.

Now, what we would like to suggest is that this bill be given further time for consideration. I know that we are confronted with an October 31 date, I believe it is, when the committee is supposed to bring a bill to the floor of the Senate. But we think that it is too important to the country for us to run through any such bill, and we think that there is a lot of work that the Senate Finance Committee can do on this bill before it is presented for action by the Senate.

We think that the tax proposals in the House bill for State and local bond interest, the oil industry, the capital formations market, contributions to schools and other institutions, the obvious trend toward a gross income tax, the attacks on the foreign credit and so on all are wrong for the Nation and our economy. Because of a few isolated and frequently misrepresented cases, the whole Nation should not be penalized.

Take the case of State and local bond interest. There is according to my research still an outstanding and valid, although questioned by many, Supreme Court decision holding that State municipal bond interest is not subject to Federal income tax. We do not hear much about constitutional arguments any more in respect of taxes, but I notice that the Treasury Department alludes to it in its statement. But I just want to point out that with respect to such interest, the statute does exempt it or until last year exempted it fully and then changed it with respect to industrial development bonds to some extent, but basically the constitution says we should not tax it according to the Supreme Court decision.

This no doubt accounts for indirect ways in which this bill attacks exempt interest. It is worth repeating that recipients of such interest do in effect pay something to the local governments involved by taking less return on their investments. Thus the local taxes of others are less.

Take capital gains. Some tax systems do not treat such gains as income at all, for which a good case can be made.

Senator GORE. Off the record.

(Discussion off the record.)

Mr. KOCH. The percentage depletion has been repeatedly shown to be something that the Nation should have.

Now as to retroactivity, which is our basic remaining point, we feel that in fairness these retroactive elements should be eliminated from the final bill in any event. For instance, increased capital gains on individuals and corporations that would apply to increments of property accruing prior to the change, inclusion of State and municipal bond interest in the LTP and allocation of deduction provisions is retroactive as to existing bonds. This is also true of the application of the LTP and allocation of deductions to capital gains, to appreciation in donated property, to excess depreciation of real estate and so on. And it also is a criticism of any application of reduced depletion rates to existing reserves in properties. Such new rates if enacted should apply only to reserves or properties discovered hereafter.

Since my time has expired, thank you very much.

Senator GORE. Thank you.

Senator Bennett?

Senator BENNETT. No questions.

Senator CURTIS. In the interests of time I will ask no questions.

Senator GORE. Thank you for your testimony.

Mr. KOCH. Thank you, sir.

(Mr. Koch's prepared statement follows:)

STATEMENT OF GEORGE S. KOCH, COUNCIL OF STATE CHAMBERS OF COMMERCE

SUMMARY

1. If the Congress should repeal the investment credit, compensatory adjustment should be made in the tax burden on corporations through adequate rate reduction or by liberalized depreciation allowances. Such action is necessary to maintain capital investment levels needed for economic growth.

2. All reasonable and legitimate costs incurred by employees in moving to a new job assignment should be recognized in the tax provisions relating to moving expenses.

3. Present rules relating to restricted stock plans should be continued but with a provision that would prohibit issuance to employees of stock other than stock of the employer corporation or of its subsidiaries.

4. The complex provisions in the bill relating to other deferred compensation should be deleted pending completion of a current Treasury study of all deferred compensation arrangements.

5. Revisions in existing provisions relating to the foreign tax credit should be deleted and the subject should be considered in relation to the overall subject of foreign source income taxation on which the Treasury plans to submit recommendations to Congress at a later date.

6. Percentage depletion allowances have served the nation well, both as to defense and consumer costs, and have not resulted in unwarranted aftertax profits to etxractive industries. Present allowances should be retained.

7. The objective of reform provisions in the bill relating to depreciation of buildings can be accomplished through the recapture provisions which would eliminate capital gain treatment with respect to all depreciation claimed in excess of straight line depreciation. Accelerated depreciation should not be denied to any facilities which are used in the trade or business.

8. Certification of pollution control facilities for rapid amortization should be limited to appropriate State authorities rather than both State and Federal. Election by the taxpayer to write off the cost in any period shorter than five years would be desirable.

9. Elimination of the 25% alternative capital gains tax and extension of the holding period to 12 months would inhibit transfers of capital and new investments and should not be enacted. The 25% capital gains rate for corporations should not be increased.

10. Both the limit on tax preferences and the allocation of deductions are moves toward taxation of individual gross income and should not be enacted. The allocation is especially onerous because it discriminates between taxpayers with the same amount of income.

11. Steep progression and existing high rates for taxation of individual incomes are the real cause of many of the problems this bill seeks to meet through a maze of complicated provisions. The new individual rate schedules and the maximum rate of 50% on earned income are commendable, but this maximum should apply to all income without distinction.

12. The taxation of interest on state and local bonds through the tax preference and allocation of deductions provisions in the bill should be eliminated. Such taxation can only add to bond interest rates and increased state and local taxes.

13. Retroactive application of several provisions in the bill is inequitable and should be modified.

Statement

My name is George S. Koch. I am an attorney-at-law in New York and am Chairman of the Federal Finance Committee of the Council of State Chambers of Commerce. Mr. Eugene F. Rinta, the Executive Director of the Council, is with me today.

We are submitting a statement of our views on H.R. 13270 and ask that it become a part of the record of these hearings. Our specific views on particular provisions of the House Bill are expressed in the statement and, because of the number of subjects on which we submit our views, I shall limit my oral presentation to a general summarization.

The Council of State Chambers of Commerce is an organization which studies and formulates views on national issues for the use of its 31 member State chambers of commerce throughout the nation. As you will note at the end of the statement, 24 of such chambers have endorsed the statement which represents a virtually unanimous consensus of our Committee. The fact that some of the member State Chambers have not endorsed the statement is primarily due to lack of time for its consideration by their policy making bodies, not disagreement with the views it expresses.

The Federal Finance Committee of th Council is composed of financial and tax oriented people from numerous business enterprises and the chambers of commerce. These men are all capable of understanding the problems of Federal finance as well as the tax law since much of their time is devoted to these subjects. From these men come expressions of deep concern regarding H.R. 13270.

Never has the membership of our Committee seen in a single tax bill so much that is in their judgment wrong for our nation.

The bill would enact the "Tax Reform Act of 1969." The key to each provision, therefore, is presumably reform. When one thinks of reform the usual impression is of improvement. The basic definition of the term in Webster's Dictionary is "the amendment of what is defective." Conceding that our income tax law contains defects, changes are not justified unless they are improvements. Our position is simply that too many of the proposals in H.R. 13270 are not improvements in the true sense and should be rejected.

In our time a new principle has emerged. It is that high income taxation is so vital a consideration of business and individual decisions that its application must be understood and be predictable. Look at the market for State and Municipal bonds. Look at the confusion surrounding the 7% investment credit. While Congress can, of course, change the tax law, such changes must be tempered by what is best for the nation as well as by an awareness of and adherence to the rules of the game. This requires a thorough understanding of how the changes will work. H.R. 13270 certainly fails to meet these principles.

One needs to reflect on the fact that the objects of the so-called reforms proposed in H.R. 13270 were passed by Congress over a long period of time. May I say that they have, by and large, been put into the law over the years because they were needed. The inordinately high graduated tax rates applicable as a taxpayer's income increases have required safety valves in order to work. Capital formation and investment are imperative in order to provide jobs so people can work and be productive. But the bill attacks the very people who provide the capital. If they are eliminated, who provides it? We can guess that only the Federal Government could do it. This is, we hope, not what is wanted or expected, not to mention its inadequacy.

Generally speaking, we think that the tax proposals in the House bill for state and local bond interest, the oil industry, the capital formation markets, contributions to schools and other institutions, the obvious trend toward a gross income tax, the attacks on the foreign tax credit, and so on, all are wrong for the nation and our economy. Because of a few isolated and frequently misrepresented cases, the whole nation should not be penalized.

For example, the Supreme Court has ruled that the Federal government cannot constitutionally tax interest on state and municipal bonds. No doubt, this accounts for the indirect ways in which this bill attacks exempt interest. It is worth repeating that recipients of such interest do in effect pay something to the local governments involved by taking less return on their investment. Thus the local taxes on others are less. Take capital gains. Some tax systems do not treat such gains as income at all, for which a good case can be made. Then there is percentage depletion which repeatedly has been shown to be in the best interests of our nation quite aside from the fact that depletion at the existing rates is thoroughly integrated into the economies of the nation and industry so that no windfall from it can be identified except for the consumer. In the case of the recipients of donated property, great advantage to the nation and its people has resulted from the donor's giving up his property.

A curious factor pervades numerous provisions of the House bill. This is the frequent absence of any meaningful revenue effect or gain. With small, relatively insignificant revenue effect, how can these changes be justified as against the predictable serious and adverse effects on our economy that many foresee.

The bill passed by the House has a number of retroactive features which in fairness should be eliminated in any event from the final bill. Here are some examples. The increased capital gains tax on individuals and corporations applying to increments in property accruing before the change. Such increment often is in fact nothing but inflation and does not represent real growth in value. Inclusion of state and municipal bond interest in the tax preference provisions is retroactive as to exisitng bonds. This is also true of the application of the limit on tax preferences and allocation of deductions to capital gains, to appreciation in donated property, to excess depreciation on real estate, and so on. Any reduction in depletion rates would inequitably apply to existing reserves and properties and thus be retroactive. Such new rates, if enacted, should apply only to reserves or properties discovered hereafter.

We urge this Committee to delay its decisions on this bill so as to provide the time needed for everyone, including Congress, the Administration, taxpayers and tax specialists, to study the bill and be more nearly certain of its effects on the economy and the nation's institutions. We would suggest that at least the balance of this year is not too much time for this purpose. Given such added time, much better leigslation could be developed. What is right in fact for the nation should be right as well for political reasons.

Before concluding my oral presentation, on behalf of our Committee I wish to commend several provisions of the bill which are constructive. They include a start toward rate reduction for individuals, more realistic rules regarding moving expenses, a more equitable approach to taxing co-operatives, accelerated depreciation for pollution control items and improved income averaging.

We appreciate this opportunity to present our views to you. Our more detailed comments on specific provisions of the bill follow.

Bias against business in H.R. 13270

The estimated impact of H.R. 13270, when fully effective, would be a net reduction of $7.3 billion on an annual basis for individuals and a $4.9 billion increase for corporations. This shift in favor of consumption and against investment could produce serious economic consequences in the years ahead.

We submitted a statement to the House Ways and Means Committee in opposition to repeal of the investment credit, and we continue to believe that the credit should be retained. It helps to offset in part the adverse effect of inflation on capital recovery and, because of high labor costs, it or equivalent relief to corporate tax burdens is needed by American businesses to permit their competing in foreign markets. If the Congress should decide that repeal of the credit is desirable, compensatory adjustment should be made in the tax burden on corporations through adequate reduction in the tax rate or by liberalized depreciation allowance.

The Treasury has recognized the imbalance between corporate and individual tax burdens resulting from the House bill. The Secretary recommends a partial correction of this imbalance by lowering the corporate tax rate one percentage point in 1971 and an additional point in 1972 while at the same time reducing the net tax reduction for individuals. We commend the Administration for this action. But even with these adjustments the relative tax burden for corporations would be substantially greater than before the tax reducions of 1964 were enacted.

Individual income taxes were reduced 20% by the 1964 Revenue Act while corporation tax liabilities were cut 8%. This smaller reduction in corporation taxes was justified on the ground that corporations had the additional benefits of the investment credit and the new depreciation guidelines. Now it is proposed in H.R. 13270 that the investment credit be repealed at an annual cost of $2 billion to corporations and that individual income tax rates be reduced an average of 5% in addition to other significant reductions in individual tax burdens.

We urge the Finance Committee to weigh with care the economic consequences of the shift in relative tax burdens between corporations and individuals that would be effected by enactment of the House bill in its present form.

Moving expenses

Liberalization of existing provisions relating to employee moving expenses as provided in the bill is a step in the right direction. But the $2,500 overall limit on deduction of indirect moving expenses is not realistic when the sale and acquisition of homes are involved and on foreign moves.

In our view the reimbursed costs of employee transfers are in no sense economic income to the employees and, consequently, should be subject to income tax. In recognition of this fact, and because all but the "bare bones" expense reimbursements are now taxed to the employee, some employers provide an additional reimbursement to cover the employee's income tax on the basic reimbursement. Many employers, however, do not and may not be able to absorb this extra cost of employee relocations.

We believe it is only fair and proper that all legitimate costs incurred by new or existing employees in moving to a new job assignment be recognized in the tax provisions relating to moving expenses. Where the employer reimburses the relocated employee for loss in connection with sale of his home by reason of the job transfer, the reimbursement should properly be considered as a capital transaction rather than ordinary income.

We fail to see why a dollar limit should be included in any improvement in this area. Limiting the recognition to legitimate or normal items should suffice.

Restricted stock plans

Existing provisions relating to these plans provide for taxation of the stock only when the restrictions upon its sale, or other restrictions, expire. The value of the stock when received by the employee is treated as ordinary income and appreciation in value to the time the stock is sold is treated as capital gain. Under the bill a tax is imposed when the employee receives the stock unless it is subject to substantial risk of forfeiture. In the latter case a tax at ordinary rates is imposed when the stock becomes nonforfeitable. Present rules should be continued, but with a requirement that would prohibit issuance to employees of stock other than stock of the employer corporation itself or of its subsidiaries. This will insure an ownership as well as employment interest of the employee in the employer company and so meet the basic purpose of the plan.

The Treasury has recommended that the highly complex provisions in the bill relating to other deferred compensation be deleted pending completion of a current Treasury study of all deferred compensation arrangements. We support this recommendation.

Foreign tax credit

Inasmuch as the Treasury plans to submit comprehensive proposals to Congress relating to the U.S. taxation of foreign source income, revisions in existing provisions relating to the foreign tax credit should be deleted from the bill. The foreign tax credit should be considered in relation to the other proposals on taxing source income which will be submitted by the Treasury. Any urgency for action on the credit at this time is not apparent. In any event the provisions of the House bill do not conform to the basic reason for the foreign tax credit, which is to avoid double taxation.

Natural resources

Depletion allowances have served the nation well as an incentive for exploration and development of oil, gas, and mineral resources. Because of depletion, the availability of these resources has been far greater than would have been the case without depletion. The greater availability and supply has been an important defense asset and has held down costs to the consumer. There is no evidence that the petroleum or other extractive industries have been earning unreasonable after-tax profits. Instead, their net earnings on investments are in the same range as that of manufacturing companies generally. For these reasons the reductions in depletion allowances provided in H.R. 13270 should be deleted. Moreover, the present oil development incentives of depletion and intangible drilling expenses should not be penalized by the LTP and allocation of deductions provisions.

Real estate depreciation

The provisions in the bill revising depreciation of buildings is an example of a broad sweep approach in attacking a special problem related to investments in rental properties. In response to persistent complaints from the business community about the inadequacy of depreciation allowances, Congress in the 1954 Revenue Act liberalized depreciation for buildings as well as for machinery and equipment. Now in order to close the door to use of these provisions by high income investors in real estate ventures, the House bill would eliminate the accelerated depreciation provisions of 1954 with respect to all buildings except new residential housing. If we can accept the reduction of construction activity that would result, it would seem that the objective of the reform in this area could be fully accomplished through the recapture provisions in the bill which would eliminate capital gain treatment on the sale of real estate to the extent of all depreciation claimed in excess of straight line. In no event should present accelerated depreciation be denied to any facilities, owned or leased, which are used in the trade or business.

Cooperatives

The provisions tightening up on the taxation of cooperatives are an improvement over present law. However, the pay-out provision requiring payment in cash on patronage allocations over a 15-year period is unduly liberal.

Pollution control facilities

Accelerated amortization of pollution control facilities, as provided in the bill, is highly desirable because such facilities do not ordinarily contribute to efficiency of production. The House provision allowing five year amortization could be improved by permitting election by the taxpayer to write off the cost in any shorter period. The certification that would be required to permit rapid amortization should be limited to appropriate State authorities, rather than both State and Federal, so that certification would be more expeditious and less cumbersome.

Income averaging

Changes in present income averaging provisions in the bill are a significant improvement and simplification. While these new provisions should be adopted, with possible additional improvement in the Senate, the Treasury should continue to study the matter with the objective of still further improvement and simplificaion.

Capital gains

In our testimony before the House Ways and Means Committee on April 2, 1969, we urged that no action be taken with respect to capital gains taxation that would tend to impair the savings and capital formation that will be needed in increasing amounts for job creation and more efficient production in the years ahead. We pointed out that special treatment of capital transfers, as distinct from income, serves several important purposes.

First, the present special treatment of capital gains recognizes the distinction between capital and income, and it helps to preserve and expand the former so that the latter can continue to grow. It provides incentives for savings and investment which are basic to economic growth, and it helps to channel investment to the best uses of resources by encouraging mobility of capital. Finally, it is partial recognition that the appreciation in many assets sold is largely, if not wholly, the result of inflation rather than true increase in value.

The House bill, however, adversely attacks present treatment of capital gains in several provisions. These include elimination of the 25% alternative tax for individuals, extension of the holding period to 12 months from the present 6 months, inclusion of one-half of net long-term capital gains as a tax preference item, and increasing the capital gains rate on corporations from 25% to 30%. The Treasury has recommended that the provisions eliminating the 25% alternative tax and extending the holding period be deleted from the bill. We certainly concur with this recommendation. But we further recommend that the corporation capital gains rate be retained at 25% and that one-half of capital gains not be included as a tax preference item if Congress should enact provisions for allocation of deductions.

The bill would also eliminate capital gains treatment for the employer contributed portions of lump-sum distributions from approved pension, profit sharing, and savings programs. It appears from the Ways and Means Committee report on H.R. 13270 that an important consideration in the Committee's action was its understanding that the present provision is of primary benefit to taxpayers with income in excess of $50,000. While we do not agree that this is a valid reason for the change, we point out that this is a gross misunderstanding. The fact is that the provisions can and do benefit very large numbers of employees at modest as well as higher income levels, as testimony submitted to your Committee by employers clearly indicates.

The House provision would adversely affect all employees who look forward to a lump-sum payment upon retirement. Even though the special 5-year averaging provision might provide for an eventual refund, the amount would be unknown and, in the meantime, the taxpayer would be deprived of the use of his money. The present capital gains treatment was adopted originally to provide a fair averaging method which has the advantage of being positive and immediately known, as well as being fair. The House bill would create impossible problems for most retirees. For these reasons and because of the relatively insignnficant revenue effect, we urge that the present treatment of lump-sum distributions be continued.

Limit on tax preferences and allocation of deductions

Two related provisions in the bill—limit on tax preferences and allocation of deductions—are designed to reduce the tax benefits which are now available from certain so-called tax preferences. These preferences include tax-exempt

State and local bond interest, one-half of net long-term capital gains, appreciation in property donated to charity, depreciation claimed in excess of straight-line depreciation, and farm losses under certain circumstances. Both the LTP and the alloction of deductions are a move toward taxation of individual gross income and should not be enacted. The allocation of deductions provision is especially onerous because it discriminates between taxpayers with the same amount of income.

Maximum tax on earned income and individual income tax rates

Limiting taxation of earned income to a maximum of 50% and the new individual rate schedules proposed for all income both are commendable. They move in the direction of lessening the impact of the steep progression of the deadening present income tax rate schedule. Existing high rates are the real cause of many of the problems this bill seeks to meet through a maze of complicated provisions. We suggest that the maximum rate on all income without distinction should be 50%.

State and local bonds

Interest on state and local bonds should not be subjected to Federal income tax. The House bill does not provide specifically for taxing such interest but it does indirectly by including this interest as a tax preference item in both the 50% limit on tax preferences and the allocation of deductions provisions. Thus interest on presently outstanding state and local bonds, as well as future issues, would be taxed when the taxpayer's tax preference items including such interest exceed 50% of total income as a result of the LTP. Further, when the taxpayer's preference items exceed $10,000, his interest on state and local bonds will contribute to a loss of deductions under the allocation of deductions provision.

It is obvious that the unprecedented needs of state and local governments for debt financing will continue to grow in the years ahead. Even under the best of circumstances, including the present exemption of bond interest, the financing problems of these governments will be substantial. Clearly, the provisions of the House bill affecting exempt interest will aggravate their problems. In addition to the direct adverse impact that these provisions will have on interest rates of state and local bonds, the fear on the part of investors that the exemption may be further eroded by future Congressional action will add to interest costs. The end result can only be increased taxes at the state and local levels to cover the higher financing costs.

The Treasury has recommended deletion of state and local bond interest as a preference item in the LTP provision but supports its inclusion in the computation for allocation of deductions. We urge its deletion from both.

Retroactivity

The bill in several instances in effect calls for retroactive application of proposed changes. Such retroactivity is objectionable and inequitable, and should be eliminated. Among the major provisions in which retroactive application is involved are the following: application of increased capital gains tax on individuals and corporations to appreciation in property accruing before the change in tax rate; inclusion of exempt interest on presently outstanding bonds in the limit on tax preferences; application of the LTP and allocation of deductions to prior appreciation in property sold or donated; and application of reduced depletion rates to existing reserves and properties. No doubt there are other significant instances of retroactivity in the bill.

The following State Chamber organizations have expressed basic agreement with Mr. Koch's statement:

Alabama State Chamber of Commerce
Arkansas State Chamber of Commerce
Colorado Association of Commerce & Industry
Connecticut State Chamber of Commerce, Inc.
Delaware State Chamber of Commerce, Inc.
Florida State Chamber of Commerce
Georgia State Chamber of Commerce
Idaho State Chamber of Commerce
Indiana State Chamber of Commerce
Kansas State Chamber of Commerce
Kentucky Chamber of Commerce
Maine State Chamber of Commerce

Montana Chamber of Commerce
New Jersey State Chamber of Commerce
Empire State Chamber of Commerce (New York)
Ohio Chamber of Commerce
Pennsylvania State Chamber of Commerce
East Texas Chamber of Commerce
South Texas Chamber of Commerce
West Texas Chamber of Commerce
Virginia State Chamber of Commerce
West Virginia Chamber of Commerce
Wisconsin State Chamber of Commerce
Michigan State Chamber of Commerce

In endorsing Council statements, such as this one, dealing with many issues and considerable technical detail, the member State Chambers reserve the right to take exception in one or more particulars.

The Connecticut State Chamber wishes to be recorded on the percentage depletion question as supporting adequate depletion allowances to assure essential supplies of oil and gas for energy purposes, but without specifying the appropriate percentage allowances.

The Delaware State Chamber had not resolved a position on the natural resources issues discussed in this statement.

Senator BENNETT. Mr. Chairman, there is among the list of witnesses a very good personal friend of mine from Salt Lake City, Mr. Adrian Pembroke who is down as No. 12. I must go down to the Department of the Interior to a signing ceremony, and I would like to hear Mr. Pembroke before I go. I will not have to leave here for another 20 minutes, but if it is all right at this point I would appreciate it if you would call Mr. Pembroke.

Senator GORE. Mr. Pembroke, we are very pleased to have you, and particularly since you are a friend of Senator Bennett.

We shall be glad to hear from you, sir.

STATEMENT OF ADRIAN H. PEMBROKE, REPRESENTING THE NATIONAL OFFICE PRODUCTS ASSOCIATION AND THE BUSINESS PRODUCTS COUNCIL ASSOCIATION

Mr. PEMBROKE. Thank you, Mr. Chairman.

I will not take too much time introducing the people.

Senator BENNETT. Mr. Pembroke as I said is a long-time personal friend. I suppose I might say that Adrian and I are classmates of sorts, having taken a special economic training course back in 1948 and 1949. He is the operator of a small wholesale-retail office supply and stationery business in Salt Lake. He is a past president of the National Office Products Association and past president of the National Business Products Council Association. The first is a general association with 5,000 members, the second has about 65. These are all small independent dealers in the field in which Mr. Pembroke works, and I understand he is speaking for these two groups here today.

Mr. PEMBROKE. Thank you very much, Senator Bennett and Mr. Chairman.

I am pleased to be here to speak for these over 5,000 small independent businesses scattered across the country. We are in a very fast-moving industry, the office products industry. Growth and the necessity of growth is the reason we are here.

Our competition includes such giants as Xerox, IBM, Kodak, and others. Our statement requests either the repeal or the amendment of sections 531 through 537. I will try to summarize.

No. 1. This part of the code deals with the accumulated earnings tax, and we contend that this tax is really a penalty. It is too complex to be coped with by small corporations.

The accumulated earnings tax is applied only to closely held corporations which are for the most part small businesses. Large corporations have few problems with this particular part of taxation.

As a result, it gives them a very definite competitive urge.

Thirdly, growth for us must be financed through retained earnings. Financing growth with borrowed capital is unfeasible, especially in the present high-interest-rate money market.

Fourthly, we touch quickly on a recent decision of the Supreme Court in *U.S.* v. *the Donruss Company* which has made our taxpayers' life under this accumulated earnings tax even more difficult.

I do not speak as an expert on accumulated earnings taxes or on any other provisions of Federal tax law. However, as a layman who has studied the accumulated earnings tax, as it has affected my own business and those of the 5,000 for whom I speak, I have concluded it is indeed quite unlike other tax.

Neither the U.S. corporate income tax return, No. 1120, nor the instructions for its completion, contains any reference to the retained earnings tax, and there is no separate form for its reporting.

In the unlikely event that a corporation should desire to pay this tax voluntarily, its management would be hard put to find out how to do so. This lack of procedure for self-assessment clearly indicates that no corporation is expected to pay the tax voluntarily. It suggests in reality that it is not a tax but a penalty.

Our burden with this taxation is even more severe because of the complexity of the language of the parts of the code I refer to. The test for determining what is proper or improper earnings retention are so varied and complex that only the most general guidelines can be made available by the Internal Revenue Bureau.

Point 2: This tax or penalty for over-accumulation is only imposed upon small corporations. Its taxation applies to only one segment of the economy, and that part of the economy is least able, resourcewise, to defend itself.

Justices Harvey, Douglas, and Stewart, in dissenting from the decision in the case of *U.S.* v. *Donruss Co.*, said:

"In practice the accumulated earnings tax provisions are applied only to closely held corporations, those controlled by relatively few shareholders."

It can be considered unjust because it is confiscatory in nature. Despite the heavy penalty that can be suffered, many executives of small corporations learn of the existence of this earnings tax only when its imposition is proposed by the Internal Revenue Act.

Whatever the reasons for past circumstances in which our owners first learn of the tax, their reaction is sharp disbelief. They have difficulty in understanding a naturally confiscatory tax which will be imposed if they are unable to make the shows which are necessary under the statute.

The contemplation of such a procedure, and the possible result can be bitter when the Government has already taken more than half of the corporation's earnings for the year in question, and is demanding a large slice of what was left because it was not distributed as dividends and subjected to further tax by the shareholders.

Growth for us must be financed through retained earnings. Financing growth required capital is unfeasible especially with the high interest rates. Our members report that they have now been paying these high interest rates of 14 months.

The small, closely held corporation can retain profits only within certain ill-defined limits, and at the peril of being subjected to a confiscatory additional tax.

Large business has no problem with this particular section of the code.

This is a definite disadvantage in our competition with our larger competitors.

In 1958 Congress recognized the inflationary problem and increased the tax credit from \$60,000 to \$100,000. Since 1958, as you know, the dollar has declined in value 20 percent. Using 1939 as a benchmark, the present tax credit is actually worth \$38,000. That \$38,000 would not cover one month's operating expenses for many of our members. And, that \$38,000 is a real poor down payment for the kind of new buildings and facilities we require for growth, when we find out, those of us who have to build new buildings, that the costs of building have gone up at the rate of about \$20,000 to \$40,000 in the last 3 or 4 years.

Now the Supreme Court, in *U.S.* v. *the Donruss Co.*, changes the entire game for the small corporation.

In this case, the Supreme Court reversed the U.S. Court of Appeals for the Sixth Circuit. It said:

> It is not necessary that the avoidance of shareholders' tax be the sole purpose for the unreasonable accumulation of earnings.

This decision was rendered in favor of the Internal Revenue Service. It essentially shifted the burden of proof back to the taxpayer. Again our defender, Mr. Justice Harlan, in writing the dissent said:

> My difficulty with the instruction approved by the Court is that in most instances it will effectively deny to the taxpayer the last clear chance which Congress clearly meant to afford and substitute a very chancy deed.

Mr. Chairman, in conclusion, we place ourselves in the hands of this committee. We respectfully appeal to you to have someone seriously review this statute, including sections 531 through 537. If it is unfair and it is unjust, then we would recommend that it be repealed.

If it cannot be repealed, we hope you will in part overrule the decision of the Supreme Court in *U.S.* v. *Donruss Co.*. and again to shift the burden of proof back to the Internal Revenue Service.

Second, of even greater urgency, we urge your support. We need a sharply increased amount of tax credit. We should like \$100,000 of tax credit based on 1939 dollars. Hopefully we ask you to restate your intent that small growing business should and can keep adequate rainy-day reserves, and that they can build up liquidity which is absolutely essential if they are to be able to borrow money from the banks.

Thank you very much.

Senator BYRD. Any questions?

Senator BYRD. Mr. Chairman, I have no questions. I appreciate the fact that Mr. Pembroke has brought to us questions which many of us were unaware of, and I think his presentation has been very timely and I assure him the committee will look into it.

Senator BYRD. Senator Curtis?

Senator CURTIS. No questions.

Senator BYRD. Senator Miller?

Thank you very much, Mr. Pembroke.

Mr. PEMBROKE. Thank you very much, Mr. Chairman.

(Adrian H. Pembroke's prepared statement follows:)

STATEMENT OF ADRIAN H. PEMBROKE, REPRESENTING THE NATIONAL OFFICE PRODUCTS ASSOCIATION AND THE BUSINESS PRODUCTS ASSOCIATION

SUMMARY

1. Accumulated earnings tax is really a penalty, the liability for which often arises from ignorance, bad advice, misunderstanding, or mistakes in business judgment. It is too complex to be coped with by small corporations. It should be repealed.

2. The accumulated earnings tax is applied only to closely-held corporations which are for the most part small businesses. Large, publicly-held corporations with which small businesses must compete don't have the problem. This gives a competitive advantage to big business in addition to all of its other advantages.

3. Growth must be financed through retained earnings. Financing growth with borrowed capital is unfeasible, particularly in the present high-interest rate money market.

4. The recent decision of the Supreme Court in *U.S.* v. *The Donruss Company* has made the taxpayer's life under the accumulated earnings tax even more difficult.

5. If the statute cannot be repealed, amend it to make it easier for small business to live with it.

(a) Overrule in part the *Donruss Company* decision.

(b) Do something further to alleviate the taxpayer's burden of proof.

(c) Increase the amount of the minimum accumulated earnings credit to reflect the changes in the value of the dollar due to inflation since such credit was fixed at $100,000.

STATEMENT

My name is Adrian H. Pembroke. I live in Salt Lake City, Utah, where I own and operate a small business. I am a Past President of the National Office Products Association, of Washington, D.C., and a Past President of Business Products Council Association, of Chicago, Illinois. The first of these associations, as its name indicates, represents business organizations engaged in the manufacture, distribution and sale of office products. It has more than 5,000 members. The second association has about 65 member organizations which are dealers in 100 cities in the United States in the products, including office equipment, of a major manufacturer. All the members of each association are independent dealers. Most of them are small, family-owned or otherwise closely-held corporations. The office products sales business which I operate in Salt Lake City is conducted through a corporation owned by me and my family. It is a member of both of the associations which I have named, and it would be middle-sized among the membership of each association.

I have been authorized by each association to present on its behalf views opposing the retention in the Internal Revenue Code of the provisions relating to Corporations Improperly Accumulating Surplus, Sections 531 to 537, inclusive,, or, in the alternative, if such provisions must be retained, some recommendations for changes.

I do not and could not speak as an expert on the accumulated earnings tax or on any other provision of the federal tax laws. However, as a layman who has studied the accumulated earnings tax as it has affected my own business and similarly situated businesses among our membership, I have concluded that it is indeed quite unlike any other tax. Neither the U.S. Corporation Income Tax Return (Form 1120) nor the accompanying instructions for its completion contains any reference to the accumulated earnings tax and there is no separate form for its reporting, nor, unlike the personal holding tax imposed by section

544 of the Code, any schedule for its computation or reporting. In the unlikely event that a corporation should desire to pay the tax voluntarily, its management would be hard put to find out how to do so. This lack of procedure for self-assessment clearly indicates that no corporation is *expected* to pay the tax voluntarily, and suggests that it is really not a tax but a penalty. And it appears that, too often, liability for the penalty arises from ignorance, bad advice, misunderstanding or mistakes in business judgment rather than from the type of abuse that the provision is designed to prevent. Federal taxation is inherently complex, but a businessman can, on his own or with professional assistance, determine with some degree of certainty the probable tax consequences under many sections of the Internal Revenue Code. Not so with the accumulated earnings tax.

A small, closely-held corporation is more often than not confronted with uncertainty about the consequences of a proposed retention of the earnings of a given year for what he considers to be the reasonable needs of the business. The tests for determining what is a proper or an improper accumulation are so many and varied, and complex, that only the most general and obvious guidelines can be made available by the Internal Revenue Service in its regulations or by the advice of private practitioners of tax law.

Despite the heavy penalty that can be suffered, many executives of small corporations learn of the existence of the accumulated earnings tax only when its imposition is proposed by an Internal Revenue Agent or through information disseminated by trade associations such as ours. Whatever the reason for past ignorance or the circumstances in which such executives first learn of the tax, their reaction is one of shocked disbelief, which is followed quickly by consternation. They have difficulty in appreciating a nearly confiscatory tax which will be imposed if they are unable to make the showings which are necessary under the statute, the Income Tax Regulations and the judicial decisions, if the presumptions against the taxpayer are to be overcome. The contemplation of such a procedure and the possible result can be particularly bitter when the Government has already taken more than half of the corporation's earnings for the year in question and is demanding a large slice of what was left because it was not distributed as dividends and subjected to further tax at the shareholder level.

When the executives of a small corporation learn further that the accumulated earnings penalty is rarely, if ever, imposed on any of the large, publicly-held corporations but has to be coped with only by corporations the ownership and control of which are in a small group of stockholders, there is understandable indignation. The independent dealers in office products who are members of our two associations must compete directly with the giants in the office products manufacturing business who sell their products through company-owned stores. Such corporations have no problems with respect to the retention of earnings for the financing of expansion of facilities or other growth. Retained earnings are the principal source of their financing and, in addition, they have great borrowing power, both with lending institutions and with the public. In contrast, small corporations do not have ready access to the money markets. Such borrowing as they can arrange is frequently, in reality, borrowing by the shareholders who must guarantee repayment of the loan which is made to the corporation. Such borrowing is ordinarily short-term. The retention of earnings is essential for the growth of any business. The large, public-held corporation retains its earnings with immunity from any Government action comparable to the accumulated earnings tax and with responsibility only to its shareholders. The small, closely-held corporation can retain profits only within certain ill-defined limits, at the peril of being subjected to a confiscatory additional tax.

The competitive disadvantage is obvious. Such disadvantage is particularly acute at times such as these with the high-interest rate money market which has persisted for some 14 months. This, for practical purposes, precludes even the financing of growth with borrowed capital. It is not surprising that many dealerships in all lines of merchandising have recently been taken over by the manufacturer.

The executives of a small corporation may also be faced with a major problem in the area of planning for the future of the business. Inability to get capital from normal capital sources necessitates primary reliance upon the resources of the corporation or the personal assets of its stockholders. These executives must plan in advance for future expenditures because the amount of capital that is necessary to make, for example, a major modification in a building, in a product line, or to accomplish any sizeable expansion, is more than can be obtained in a short period of time. Thus, the accumulation of capital must be made over a period of years.

Executives who look back over the last several years have reason to be very discouraged. This has been a period of almost constant inflation which has recently accelerated. The small businessman whose corporation needs a new building must consider carefully the fact that if it is to be built four years from now, the business must save not what is indicated by present cost estimates, but the additional amount necessary to cover the inevitable price increases with which he will be confronted when construction is commenced.

A building which could be built today for $100,000 may cost $130,000 or $140,000 four or five years from now. We have all watched the price increases in labor generally and in the construction industry specifically, in the cost of money, in the cost of materials, and in the cost of land. This is all very discouraging to the small corporation with aspirations to become larger; and the possibility of being faced with a substantial penalty if the Internal Revenue Service does not agree with his approach in planning for potential future expenditures or obligations adds to the discouragement.

As the small businessmen operating in the corporate form for whom I speak learn more about the scope of section 531 and its administration, they see it rightly or wrongly as a statutory license for Revenue Agents to second-guess the business judgment of management. Many of the questions requiring exercise of business judgment are of an indeterminate nature. For example, management may believe that it is facing a period of industrial upswing when the corporation can expect to do a much greater volume of business which will require more cash, more inventory and the carrying of more accounts receivable. The corporation retains the earnings of a particular year upon the basis of these business forecasts. The upswing does not materialize. Instead, there is a recession which results in lower inventory and receivables and greater liquidity. The working capital forecasts have proved to be wrong. The Revenue Agent, examining the return for the particular year—two or three years later—says, "It is clear that your corporation didn't need the earnings that it retained," and proposes the imposition of the accumulated earnings tax. Thus, the small businessman has to be *right* in his business forecasts and judgments, even though most of the economists in the country, including the President's economic advisors, may have been wrong at the same time.

Or, take the case of a retention of earnings for a planned plant expansion or for necessary improvements or repairs. The need may be obvious but management may be doubtful as to when the need should be fulfilled because of rising costs, labor problems, and fears, doubts and uncertainties, shared perhaps by many of the Nation's economists, concerning the general business outlook. Revenue Agents are not at all sympathetic about these fears, doubts and uncertainties, however real and justified. They are interested in seeing evidence of actual commitments, well documented both in the corporate minutes and in contractual arrangements. Again, the small businessman has to be certain or at least venturesome when everyone else is uncertain or cautious about commitments.

Then there is the case of the small corporation which distributes the earnings of a profitable year because of the ever-present threat of the accumulated earnings tax and its heavy penalties. A sharp drop in prices occurs subsequently and the potential profits in current inventories are dissipated. This may lead to insolvency which could have been avoided by the retention of profits which would have provided an adequate cushion.

Take the actual case of one association member. Fortunately, its management was timely advised that there would be vulnerability to the accumulated earnings tax at the end of the then-current year. The corporation distributed the earnings of that year as dividends and elected to be taxed thereafter under the provisions of Subchapter S of the Code. It is now being told by the manufacturer of the products which it sells that it must prepare for a doubling of sales, which will require the doubling of facilities and of capital requirements. Independent dealerships are continued only by ability to grow and fulfill the demands of the manufacturer. Management of the corporation now wishes that it had a cushion of accumulated earnings at the corporate level to meet this development which was unforeseen at the time it became aware of approaching vulnerability to the section 531 tax.

The operation of the statute under its administration and interpretation does not permit the putting aside of amounts for unforeseen developments or in anticipation of a "rainy day." The pitfalls inherent in the retention of earnings without any real purpose to avoid the imposition of tax on shareholders are simply too formidable and complex for the management of small corporations of the type represented by our associations. After a corporation has retained earnings of more than $100,000 it must be prepared to prove with considerable precision what the reasonable needs of the corporation were at the end of any year when all or a substantial part of the year's earnings were not distributed as dividends. It must now, after the decision of the United States Supreme Court in *U.S. v. The Donruss Company*, 393 U.S. 297 (1969), establish by a preponderance of the evidence, whatever that means, that tax avoidance with respect to shareholders was not "one of the purposes" for an accumulation. The practical effect of this decision, I am informed by counsel, is that a family corporation such as is typical among the members of our associations, must document in its records such overwhelming proof of the business need for the retention of earnings, and of the plans and commitments for satisfying the need, that avoidance of imposition of tax on shareholders which would have resulted if the earnings had been distributed will clearly appear to have been of minor significance. But, of course, every shareholder is aware that he will pay more tax individually if he receives a dividend than if he does not receive it, and if an amount that has been retained for a purpose which is subsequently determined not to be a reasonable need of the business is large enough, it will be difficult to say honestly that the tax effect at the shareholder level should be disregarded as a purpose which was not significant in the determination of dividend policy.

I am also informed by counsel that the activities of Revenue Agents in the section 531 area have increased substantially since the handing down of the *Donruss Company* decision by the United States Supreme Court. From the point of view of the Revenue Agent, this is as it should be and if one should voice objections to the unfairness of a particular application of the accumulated earnings tax, the obvious answer by the Revenue Agent would be that the objection is one that should be made not to him or to the Internal Revenue Service but to the Congress. That is our purpose in making this appearance.

We sincerely believe that this tax, as it applies and as it is administered, is unfair to small, closely-held businesses which must compete with big businesses unaffected by this tax; that it stifles expansion in prosperous times; that it is an obstacle to sound planning and fiscal policy; and that the harm that it does to small business is not compensated for by the prevention of the abuse at which it is aimed. We recommend its repeal.

We are aware that repeal of the statute has been urged at various times since the enactment of the first accumulated earnings tax by the Revenue Act of 1913. Since it has been kept on the books, it is obvious that it has been the belief of the Congress that the accumulated earnings tax performs a legitimate and necessary function in our tax policy. We would hope that the changes in our economy that have been occurring in recent years, particularly due to inflation and increases in interest rates, the increasing disadvantages under which small business competes with big business, the increasing confusion created by judicial decisions and Internal Revenue Service positions, the decrease in the disparity between corporate rates and individual rates which may be decreasing even further, may be considered valid reasons for repeal of the penalty tax. However, if the Congress, in its wisdom, decides to retain the provision, we would like to see it modified in ways that will make it easier for the executives and other representatives of small corporations to live with it, to make predictions concerning vulnerability to the tax, and to avoid its pitfalls in the never-ending potential of expensive, time-consuming and frustrating controversies with the Internal Revenue Service.

First, we would like to see the statute amended to overrule in part the decision of the Supreme Court in the *Donruss* case. As herein previously indicated, and as indicated in the dissent by Mr. Justice Harlan in that case, it will be extraordinarily difficult for a taxpayer to prove that the knowledge of tax savings, which will almost always be present when earnings are retained instead of being distributed as dividends, did not play some part, however slight, in the decision not to distribute. The statute should be amended to provide a "but for cause" test which would allow the Government to prevail if it can show, with the aid of the section 533(a) presumption, that taxpayer would not have accumulated the earnings if it had not been for the tax saving at the shareholder level, and which would permit the taxpayer to escape the tax if it can show that the earnings would have been accumulated even had no tax saving been possible. Such an approach would give effect to the section 533(a) presumption and enable the imposition of a penalty upon a taxpayer which had a "purpose" to avoid the tax, and, on the other hand, it would afford the taxpayer an opportunity to prove the existence of a purpose "to the contrary."

Without specifying how it may be accomplished, we strongly believe that something further should be done about the burden of proof in accumulated earnings tax litigation, and that the application should not be restricted to Tax Court proceedings. A proceeding which leads to litigation of an accumulated earnings issue starts with a statutory notice which simply states that it has been determined by the Commissioner that earnings of a particular year in excess of the reasonable needs of the business have been retained by the taxpayer (or words to that effect). There is no specification of the facts or conclusions upon which such determination is based. The taxpayer must take it from there and is placed in the position of having to negate the existence of all the possible facts or circumstances upon which the Commissioner may have based his determination. This is too great a burden, particularly for the small corporation with limitations upon the amounts it can spend for legal advice and assistance in so complex an area of the law.

At the very least, we recommend that the amount of the minimum accumulated earnings credit provided for by section 535(c)(2) of the Code be increased substantially. The value of the dollar has been decreased so greatly by inflation since the credit was raised from $60,000 to $100,000 in 1958 that the necessity for a further increase is clearly indicated. When this increase occurred in 1958, the House Committee Report (85th Cong., 2d Sess., H.Rep No. 2198 (1958) 6) which accompanied H.R. 8381, amending section 535(c) of the 1954 Code, stated as follows:

"Your committee has increased this $60,000 minimum accumulated earnings credit to $100,000. The accumulated earnings tax has presented an especially serious problem for small business, because the absence of specific plans frequently makes it difficult for small business to establish the reasonable needs of the business for accumulated earnings. It was in fact this which initially led to the $60,000 minimum credit in prior years. By raising this amount to $100,000, your committee makes allowances for rising costs since this figure was first established and also provides a slightly wider margin of accumulation with respect to which business can be free of worry concerning the accumulated earnings tax. It should be made clear, however, that this increase in the minimum credit is not in any way intended as an indication that accumulated earnings in excess of $100,000 are necessarily subject to this special tax."

The foregoing reasons, which prompted the increase from $60,000 to $100,000 in 1958, apply with even greater force today after ten years of inflation. The amount which a corporation should be permitted to retain with no questions asked should be equated to the decrease in the value of the dollar.

If the higher brackets of the individual income tax rates are to be lowered, it is assumed that there would be a correlative change in the 27½ percent rate for imposition of the accumulated earnings tax on accumulated taxable income not in excess of $100,000 and in the 28½ percent rate on accumulated taxable income in excess of $100,000, provided by sections 531 (1) and (2).

I appreciate very much this opportunity to present views of our association members concerning the accumulated earnings tax.

Senator BYRD. The next witness will be Stanley Nitzburg, tax counsel, Commerce and Industry Association of New York.

We shall be glad to hear from you, sir.

STATEMENT OF STANLEY NITZBURG, TAX COUNSEL, COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK

Mr. NITZBURG. Thank you.

Commerce and Industry Association is the largest service chamber of commerce in the Nation. Our membership consists of companies in every field of endeavor and range in size from the small family corporation to the Fortune 500. The viewpoint I will present is the viewpoint of the majority of New York business.

We believe that the House, in its efforts to meet public clamor to tax 155 wealthy taxpayers, has produced a bill with three major failings.

The first is the bill is inflationary rather than anti-inflationary. The provisions for tax reduction are untimely. They are inconsistent with other provisions in the bill which are intended to curtail inflation, such as the surcharge extension.

They generate additional funds for consumer spending at a time when every effort is being made to reduce spending and tighten the supply of money.

The second failing is that the bill attempts to fragment the prosperity of the economy. Even if the bill generated as much revenue as is lost from the reductions in individual tax, it is done by trading business tax dollars for individual tax dollars.

The bill does this directly. Section 461 increases the alternative capital gains tax on corporations from 25 to 30 percent, with an estimated revenue increase of $175 million, and it does it indirectly by termination of the investment credit with an estimated revenue increase of $1.35 billion in 1970 rising to $3.3 billion when it is fully effective.

The repeal of the credit is done ostensibly because it contributes to inflationary pressure. However, President Nixon, in requesting the repeal said:

"The repeal of the investment credit will permit relief to every taxpayer through relaxation of the surcharge earlier than I had contemplated."

We believe that the credit encourages modernization and permits increased production at a lesser cost, and actually has had an anti-inflationary effect. We do not see this time as an appropriate time for political meddling in economic problems, namely trading off economic growth for voter approval.

Moreover, we do not understand how middle-income and other persons are going to prosper if the competitive position of business in world markets is burdened by higher taxes and lost incentives. The sales lost through higher prices means reduced production and that in turn will mean lost jobs.

While this bill makes competition more difficult for American business, other legislation is pending which will impose protective barriers in an effort to maintain domestic sales, and in addition to protective legislation, there are bills such as H.R. 13715 which will preserve the drawback on duties and extends the drawback concept to indirect taxes.

So there seems to be an awareness of the increased pressure from foreign markets, but H.R. 13270 is inconsistent with this effort to sustain the position of American business in international commerce.

The third major failing of the bill is that it sacrifices simplicity. Some of the formulas and interrelated provisions contained in the bill seem so complex that we question whether they are completely understood even by the draftsmen. We certainly do not think that it is possible to create a greater sense of tax equity and fairness with provisions that cannot be understood.

It is interesting to note that when the problem requiring reform is faced, the bill manages both equity and simplification, and that would be a section such as 311, income averaging, but when the problem is avoided, you have a complex provision such as 302 allocating deductions, which makes a backward attempt to cope with tax reference income and manages to ignore basic tax principles as well as establish principles of existing law.

We feel that unless reform is achieved with relative simplicity we are only deceiving ourselves by trading in an old problem for a new problem.

I would like to comment on two specific sections. The first is moving expense. When Congress originally passed section 217, it recognized the need to have a mobile labor force. Obviously one reason was to encourage unemployed labor to move to an area of job opportunity.

Equally important was recognizing that modern business operations are multistate operations, and it is often necessary to shift employees from one location to another.

Section 231 of the bill attempts to bridge the gap between the current treatment of moving expense and reality. The present law ignores the fact that the transferred employee must find a place to live at his new employment location. It ignores that when a move is made, some temporary living accommodation is necessitated by delay in occupancy or by a misdirected moving van.

The third factor is the expenses incidental to the sale and purchase of a home. These items are all real costs of a move both for the newly employed and the transferred employee. They represent the financial burden which is added on to the emotional disruption that is involved in every family move.

Although the bill would permit deduction of these indirect moving expenses, it imposes an inadequate dollar limit, and that amount is $1,000 on both the cost of seeking a new residence and the cost of temporary accommodations. A company reimbursing its employees will limit the expense that a husband and wife incur in searching for a residence at a new location. But when a low dollar limit on the deductible expense is set by legislation, you are in effect saying that the house-hunting expense is not deductible, if you get a job or get transferred too far from where you are currently living, or in other words, do not move from West Virginia to California. Move from West Virginia to Pennsylvania and then you will be all right.

Business in New York has had problems in transferring men into the area. The cost of living is high and a number of problems are presented which are not answered by additional compensation. But when a man is transferred in, and he and his family are awaiting the arrival of a moving van which was last heard from somewhere in Indiana, you cannot expect by New York City standards to house a family of four or five for 30 days at a cost which when added to the house-hunting cost will still be within this $1,000 limitation.

We suggest that no limit be set for these expenses. They should be kept within the concept of reasonableness that pervades the entire section.

We also believe that temporary storage charges should be allowed as a deductible expense, not subject to a dollar limitation, but as a general expense under the (b)(1)(A) provision. Neither of these changes should result in a significant revenue loss.

Just a word on section 331 which imposes a tax on so-called deferred compensation. By not defining deferred compensation you are interfering with valid contract arrangements for postemployment consulting as well as the agreements that affect noncompetition and retention of trade secrets. They may very well be included now as taxable items where they are not within the gamut of problems with which the section purportedly is attempting to cope.

I might note that revenue gain from section 331 is minimal. It is only $5 million in 1972, and the section does not really serve the purpose that it is intended to serve.

In conclusion, I would like to express our association's support of this committee's effort. We trust it will result in a true tax reform bill that will benefit the entire economy without penalizing the business and investment community.

Thank you for the opportunity to express the position of the New York business community.

Senator BYRD. Senator Bennett?

Senator Curtis?

Senator CURTIS. You do not favor the passage of the House bill?

Mr. NITZBURG. No, sir.

Senator CURTIS. That is all.

Senator BYRD. Senator Williams?

Senator WILLIAMS. No questions.

Senator BYRD. Thank you.

Mr. NITZBURG. Thank you, Mr. Chairman.

(Stanley Nitzburg's prepared statement follows:)

STATEMENT OF STANLEY NITZBURG, COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC.

SUMMARY

1. Tax incentives are not "loopholes" but a proper part of the socially and economically justifiable dynamics of a free enterprise system.
2. Raising corporate taxes and reducing incentives for technological advancement and new plant construction adds to the competitive burden of United States business with foreign trade and will aggravate our trade and payments problem.
3. Tax relief will be attained through tax reform. Tax reduction at this time is an inappropriate response to continued inflation.
4. Our inequitable and complex system of taxation requires both reform and simplicity.
5. Approve § 121 restricting business activities of tax-exempt organizations by subjecting their unrelated business income to tax at ordinary corporate tax rates.
6. Approve § 231 which would liberalize deduction of moving expenses, but disapprove unreasonable dollar limitation imposed.
7. Disapprove § 301 which would restrict the amount of tax preference income which an individual could earn without being subject to tax.
8. Disapprove § 302 which requires the allocation of expenses between taxable income.
9. Approve § 311 which would liberalize income averaging by reducing the qualifying percentage to 120% and by including capital gains in the computations.
10. Disapprove § 331 which would impose an additional "minimum tax" on deferred compensation payments.
11. Disapprove § 401 which would penalize small business by changing the tax treatment of multiple corporations.

12. Approve § 412 which limits the application of the election to have an installment sale.
13. Disapprove § 413 which requires a pro-rata portion of original issue discount to be included in a bondholder's annual income and requires a corporation to file an information return recording the amount of discount earned by each bondholder.
14. Disapprove § 414 which limits the deduction paid by a corporation on repurchase of its convertible securities.
15. Approve § 421 which restates the existing law making stock distributions taxable where the stockholders not accepting cash or other property receive a proportionate corporate interest.
16. Disapprove § 461 which would increase the alternative capital gains rate for corporations from 25% to 30%.
17. Disapprove § 515 which would eliminate capital gain treatment on total distributions from qualified plans made to an employee in one year.
18. Disapprove § 521 which eliminates the use of the double declining balance and sum of the years digits methods of accelerated depreciation on new buildings but approve the provision encouraging rehabilitation of low-income housing.
19. Approve §§ 801–804 which would afford tax relief to individual taxpayers with a reservation as to fiscal soundness of enacting such provisions at this time.
20. Disapprove all provisions of the bill which woald have retroactive application.

STATEMENT

Commerce and Industry Association is the largest service chamber of commerce in the United States. Its more than 3,500 members represent a true cross-section of American business and industry both as to size and nature of enterprise.

We commend the effort that produced the Tax Reform Act of 1969 (H.R. 13270). Tax reform has been too often neglected, to difficult to face, and virtually impossible to effect. It should not, however, be attained by sacrificing other equally commendable objectives of government or by disavowing basic principles inherent in our economy.

The 1968 Republican Party platform stated the "imperative need for tax reform and simplification". The 1968 platform of the Democratic Party promised the elimination of corporate and individual preferences "that do not serve the national interest". H.R. 13270 meets neither objective. The ingeniously complex formulae and interrelated provisions contained in the bill are virtually incomprehensible and can only result in taxpayer confusion and administrative headaches. The restriction and repeal of so-called "loopholes" may satisfy public clamor, but such action does not take into account the effect on the national economy.

Incentives are not "loopholes"

The capitalistic system we know, has made this country a world leader in social and economic achievement. It will sustain our continued effort to eliminate poverty and raise our national standard of living. Such a system must allow and encourage the accumulation, investment and reinvestment of capital. Such a system must encourage individual initiative, creativity and work, providing a higher reward for the greater accomplishment. Our tax laws often encourage and support some of these activities.

Enforcement of private investment and private philanthropy is clearly preferable to expanded government activity. Accelerated depreciation, the investment credit and other tax relief provisions now under attack, actually provide the impetus for new plants, technological improvement and expanded productivity at reduced cost. This is essential for real growth and is the cornerstone of our vitality. Such provisions do not constitute "loopholes". They are the safety valves on high tax costs and a proper part of the socially and economically justifiable dynamics of a free enterprise system.

Aggravating our trade and payments problem

The pending legislation is politically expedient rather than economically sound. Shifting the individual's tax burden to corporations will have a short-lived beneficial effect. The prosperity of this nation cannot be fragmented. Labor cannot prosper unless business prospers, and the prosperity of business is not determined solely by its ability to sell in domestic markets. International trade must be in balance for true economic growth to take place, and the balance has been askew.

The primary reason for United States business having less of a share in world markets is simply the higher price of our products. Cost increases in the form of exorbitant wage rises has been a major contributing factor. Contracts with wage increments of more than 30% over three years are no longer rare and 60% hikes have been won by building trade unions.

Higher tax costs and inadequate inducements to export are other factors. Yet this bill raises corporate taxes, reduces incentives for technological advancement and new plant construction and in other respects adds to the competitive burden of business. In doing so the bill intensifies the pressure on rising prices.

Higher priced United States goods will be less welcome in foreign markets while the domestic market will be inundated by imports. The aggravated imbalance of trade will result in a new spate of demands for remedial legislation. Corrective legislation cannot be effective so long as the source of the problem is ignored, namely, higher costs due to higher wages and lost tax incentives.

The existing incentives are inadequate and should be expanded rather than restricted. This was the conclusion reached in a study published by the Department of Commerce:

"Increasing the investment tax credit from 7 to perhaps 14 percent either for trade-sensitive industries or for all industries would provide a powerful added incentive to modernize manufacturing plants and could significantly increase U.S. competitiveness in international trade both on the import and export sides. Such a step, however, would have to be carefully weighed against the loss of U.S. tax revenue and other economic considerations, and might be put forward when tax reduction becomes possible. If, however, the U.S. trade balance continues to worsen, the proposal should be given urgent consideration." (U.S. Department of Commerce, "A Five Year Outlook With Recommendations for Action", April, 1969, p. 76.)

Tax relief through tax reform not tax reduction

The need for tax relief at both the individual and corporate level is inappropriately achieved at this time by tax reduction. Tax relief will be attained by true tax reform. Reform, however, does not call for the repeal of incentives. It demands the elimination of abuses and distortions of the intended purpose of existing provisions. It demands reestablishing the statutory broad tax base and the consistent application of effective rates. This will in turn produce tax relief in that tax revenue will be maintained, if not increased, and the tax burden will be properly distributed.

The case for tax reduction at this time is based on emotionalism. It is unquestioned that net income after taxes buys less today than it did five years ago, but this is the result of inflation and not of higher taxes. The Revenue Acts of 1962 and 1964 reduced tax rates for individuals. Except for the surcharge, the rates have remained the same and the amount of tax has been a stable cost in the taxpayer's budget.

The family budget can only be brought back into balance by the successful continuation of the fight against inflation. This bill attempts to check inflation by extending the surcharge, repealing the investment credit and imposing restrictions on accelerated depreciation. It inconsistently fuels inflation by contributing new money to the flow of commerce in excess of the amount generated by all the restraints and so-called reforms combined. Clearly, curtailment of capital expenditure by business while stimulating consumer spending can only result in continued inflation and crisis.

Although Congress is appropriately responsive to demands of the electorate for tax reform, it is inappropriate to accept a demand for tax reduction which cannot be enacted if we are to have fiscal integrity. Increased spending and reduced taxes are incompatible and cannot be achieved. If taxes are reduced, government spending at present levels cannot be sustained without creating another monetary crisis. The Viet Nam conflict still takes its toll in human and financial resources and, even with the surcharge in effect, a balanced budget is hard to maintain. Federal programs of proven value have been curtailed because of insufficient funds. New and innovative programs to cope with long-standing domestic problems have been shelved because revenue is lacking. This is reality.

Tax reduction is wishful thinking and not todays reality. The people of this country are mature enough to accept in government the same responsibilities they accept in their own households, namely, sound budgeting and fiscal integrity. Borrowing affords only temporary relief before it adds to the burden. At the national level the annual interest expense to carry debt is in excess of $16 billion. It is time to reassert and follow the principle that only one dollar is to be spent for each dollar earned, rather than burden future generations with our fiscal follies.

Tax equity and simplicity

We should seriously question whether there ever can be a truly equitable system of taxation. It is unlikely that historical research will uncover a prototype tax system which we can adopt or adapt. We might also question whether there is any ultimate good to be obtained in working toward a theoretically equitable system if it will be so unwieldy and complicated that, except for the creative originators, and a handful of skillful practitioners, it will not be understood. Moreover, an equitable system might not receive the expected acclaim if work incentives are stultified, if capital investment is discouraged, if persons on a poverty level are required to bear a minimum burden of taxation in exchange for the privilege of voting and enjoying the basic benefits of national government, etc. Such a system may, in fact, cause substantial economic disruption and political unrest.

A more basic question is whose sense of equity is to provide the guideline for taxation. The divergence of opinion amongst just and equitable men as to what is equitable may never be resolved. Resolution is further complicated by dynamic changes in economic conditions.

We acknowledge that our present tax system is not equitable. An extra exemption is afforded a blind person, but not a deaf person, quadruple amputee or other equally handicapped person. This is an accepted part of our tax code, but lacks reason and equity. No one would suggest removing this additional exemption, yet the revenue strain and administrative difficulty of extending an additional exemption to all handicapped persons prevents such "reform."

Stockholders are still subjected to double taxation on their investment return, once as corporate income and again as dividend income. Hardly equitable, but a part of our tax law.

We begin, therefore, with an inequitable system of taxation which is overly complex, difficult to follow and difficult to enforce. Clearly, there are many improvements which can be made to further the sense of fairness and further simplicity in administration.

But fairness and simplicity are equally important objectives that complement each other. Nothing is to be gained by sacrificing one to the other. The complexities of our tax system are, in part, the progeny of inequity. Simplification and reform are possible when we deal with the cause rather than the symptom of inequity. H.R. 13270 fails to do this. Its complexities challenge the intellect of the expert tax practitioner. There are too few such experts available to help implement these provisions. Tax paying and tax practice will become more of a challenge than it is now. Ignorance and inadvertence will play an increased part in tax avoidance and further undermine public confidence.

We believe that every individual who has substantial income also has a responsibility to pay a fair share of tax. In an attempt to reach this objective, the present bill wreaks havoc with established tax concepts, basic individual freedoms, the formation of capital and the future growth of this nation's economy. If the present bill is enacted, we will face a situation in which the proverbial forest will be destroyed in an effort to cut down the unpruned growth of 155 trees.

The positions contained in this paper further the objectives of simplification and greater equity in our tax law. They affirm the tenets of capitalism and are directed toward the continued orderly development of our national economy.

Approve § 121—Tax on unrelated business Income

The "Clay-Brown" type of transaction is an abuse of the intent of existing code provisions. Allowing such deals contributes nothing to the national interest while it reduces tax revenue. It is this type of tax avoidance which undermines taxpayer confidence. We approve of the provision requiring an exempt organization to treat as unrelated business income that portion of income which the indebtedness on acquired property bears to the total value of the property.

Many tax exempt organizations receive income from business activities unrelated to their exempt purpose. Churches, civic leagues, etc. are now permitted to enjoy such business income without paying normal corporate income tax. This constitutes a distortion of the exemption concept and results in improper government financing of the activities of the exempt organization.

Permitting unrelated business income of exempt organizations to escape tax places comparable private business endeavors at a disadvantage. Moreover, new private business undertakings are discouraged since they cannot expect to compete successfully with an established business that operates free of income tax. The revenue gain from enactment of this provision may be higher than estimated, since creating a truly competitive situation will increase business activity. It is equally appropriate to restrict an exempt organization from engaging in business through a controlled subsidiary corporation.

Recreation and family entertainment is an expanded part of our national living pattern. Clearly a personal expense, it should be paid for with after-tax dollars. To the extent that certain social clubs have been able to shelter passive investment income, they are able to provide facilities with pre-tax dollars. This is inequitable and we approve of the corrective provision which would tax such income.

We approve of the new definition of "trade or business" which treats as unrelated business income advertising revenue in excess of publication costs received by an exempt organization. The competition for advertising dollars is intense. Recently a number of national magazines have discontinued publication as a result of inadequate advertising revenue. Neither the advertiser seeking exposure, nor the subscriber reading an ad, considers the tax status of the publisher as a factor in the ad's effectiveness. Hence, there is no basis for giving favored tax treatment to the exempt publication.

Approve § 231—Moving expense

A high level of national employment is made possible by a mobile labor force. Mobility is also essential for the internal growth of nationwide business. Although Congress has recognized this in principle, the existing restrictive moving expense deduction is unrealistic and must be brought up to date.

Facilitating an employee's effort to advance his family's standard of living is in the national interest. In those cases where the move permits a dependent family to become a wage earning family, the cost of providing government assistance is avoided. A family move motivated by higher income results in an increased tax contribution.

In business today single site operations are as much a thing of the past as "mom and pop" grocery stores. Corporate employees must endure a number of moves as part of their development. In these situations, where the move is required by an employer, the employee does not necessarily receive a salary increment Even when his salary is increased his unreimbursed moving costs often will result in a net financial loss that cannot be deducted from taxable income. Full reimbursement results in some taxable income and the after-tax situation will still be a net loss.

These problems are recognized and partially treated in § 231. However, to the extent that the dollar limitations imposed are not commensurate with actual costs in today's market, the bill falls short of providing the necessary relief.

A family of four occupying temporary quarters in a metropolitan area can easily expect to spend more than $1,000 in a thirty-day period. Searching for a new home can take a few days. Hotel costs plus air fare can easily add another $600 disbursement. There should be no dollar limitation on this provision.

Although delayed occupancy of a new residence is considered, no provision is made for deducting the temporary storage charges which will have to be paid during this same period. Temporary storage charges should be included as a (b)(1)(A) expense which is not subject to limitation.

The section provides for inclusion in gross income as "compensation for services" any reimbursed moving expense Thus, the employer will have withheld those taxes normally taken on wages paid. This will result in an out-of-pocket cash loss to the employee that will not be replaced until he receives a refund on filing his annual return. Another problem is presented in a situation where the employee does not use itemized deductions. In this case, the deduction would actually be lost while the amount of reimbursement would remain in income. We recommend that reimbursed moving expenses, to the extent that they are deductible, should not be treated as "compensation for services" and should be omitted from gross income.

Disapprove § 301—Limit on tax preferences
Disapprove § 302—Allocation of deductions

We disapprove of both of these provisions as arbitrary, extremely complex and contrary to establish principles of tax law.

The bill classifies certain income as tax preference income, namely, tax-exempt interest on state and local bonds; the deduction allowed individuals of one-half of net long-term capital gains, charitable contributions of property which has appreciated in value, the allowance of accelerated depreciation on real estate and the treatment of farm loss. Section 301 introduces the new and entirely novel concept of placing an overall limitation on these so-called tax preferences for individuals. This overall limitation is imposed even though the propriety and extent of safeguards with respect to each "preference" item has been separately dealt with in other parts of the bill.

The objective of §§ 301 and 302 is to impose a higher tax on a comparatively small group of wealthy taxpayers who make extensive use of existing tax provisions and thereby pay a relatively small amount of tax. The "preference" items are still considered sound and, as safeguarded by present and proposed law, will be available in full to the average taxpayer. Hence, the socially and economically desirable effects of these provisions are retained while the politically expedient step is taken of imposing a greater tax on wealthy persons.

Creating new taxpayer classifications is contrary to the concept of equal treatment before the law. If an item is deductible, such deduction is now available to all taxpayers. Allowing deductions and permitting tax incentives to same taxpayers and not others, proposes a method of tax discrimination which has no place in our system. As precedent for future legislation, treating taxpayers differently although the taxable event is the same, marks the accelerated decline of taxpayer confidence and promises further complexity in our tax law.

Section 302 has a similar limitation provision applying to deductions and is equally novel in our federal tax system. This provision segregates non-business deductions and requires them to be allocated between taxable and tax preference income. The amount allocated to preference income is disallowed under a complicated formula. The theory apparently is that one having both taxable income and tax preference income could have paid these expenses proportionately out of both sources. Hence, it is arbitrarily presumed that he has done so regardless of any connection between income and expenses. We find such presumption to be unreasonable.

An example of tax distortion resulting from the application of this provision would be present in a situation where a taxpayer, having some preference income, realizes a substantial capital gain, i.e., on the sale of his wholly-owned business. Here the infusion of a large amount of "preference" income will result in the disallowance of otherwise deductible expenses even though the proceeds from such long-term gain were not available to pay these expenses. This formula attempt at "reform" will actually produce new inequities which will certainly require further "reform."

The most serious and significant criticism of § 302 is that it will affect the treatment of deductions that arise out of transactions completed well in advance of any proposal now embodied in the current legislation. The orderly planning and predictability of business and investment, which has always been a part of our tax laws, is unceremoniously discarded.

Both provisions create the problem of unintended tax consequences arising through the application of the formulae. Neither formula serves a sufficiently useful purpose to justify such result. The bill deals specifically with each of the "tax preference" items. We submit that the tax treatment of preference items and deductions should be made head-on. The direct handling of tax events permits taxpayers to evaluate the consequences of their transactions.

There should be no overall limitation on any kind of income nor should there be an overall arbitrary allocation of deductions. The complexity of the proposed formulae makes an exhaustive analysis of their effect impossible. This alone should be sufficient reason not to enact them.

Approve § 311—Income averaging

We approve this proposed amendment as a step toward equality amongst taxpayers and as a striking demonstration of how tax simplicity is attainable when the primary problems are faced.

Eliminating the distortion of tax liability resulting from the timing of income was the primary objective of the existing section. Excluding capital gains and certain other income from the average was done in order to avoid manipulation and because of certain misconceptions. These exclusions, however, resulted in complexity and limited use of the provision by taxpayers.

The House Committee Report stated, after discussing the amendments, "these changes will permit the elimination of 21 lines out of the 43 lines presently on the income averaging tax return form". This combination of reform and simplicity is an example of constructive tax legislation.

Liberalizing the averaging provision encourages taxpayers to take their income currently and avoids deferral schemes. It advances equity and furthers confidence in our tax system.

Disapprove § 331—Deferred compensation

The proposed change in the taxation of deferred compensation introduces two new formulae: The application of one formula requires extensive recordkeeping and places a burden on the taxpayer, matching deferred payments to income years, that can only encourage litigation. The alternative formula arbitrarily provides that if you aren't willing or able to comply with the recordkeeping requirement you must pay a higher tax since the deferred payment is related back to peak income years.

This involved procedure is intended to equate taxation of funded deferred payment arrangements with non-funded arrangements on the erroneous premise that the two are the same. The premise is incorrect since it assumes that a corporate promise of payment is equivalent to money set aside. The bankruptcy and reorganization of publicly-held corporations is not a unique occurrence. Moverover, financial misfortune in closely held companies often results in unfilled compensation promises.

A significant problem in applying the proposed section is the absence of a definition of "deferred compensation". Compensation agreements with executive personnel often include legitimate provisions for post-employment consulting. Many contracts are dependent on a post-employment, non-competition and nondisclosure of trade secrets provision. These clauses have real value to the company and are usually assigned an equivalent dollar amount. To change the timing of income by relating these negotiated payments back to the year of active employment is tax distortion and not tax reform.

We disapprove of this provision as unnecessarily complex, too vague in application, and inappropriately based on an inaccurate premise.

Disapprove § 401—Multiple corporations

This subject is almost a perennial in the annals of tax reform. Congress has repeatedly weighed the pros and cons of allowing multiple exemptions to a "controlled group" of corporations and the present law reflects this exhaustive study. No new development in the past five years warrants any change in the treatment of multiple corporations. Adequate controls are contained in our law to prevent abuse of existing provisions.

The proposed amendment will effectively restrict the competitive ability of small business and discourage new business endeavors. For example, if Mr. A now successfully runs a single unit, take-out food store and forms a new corporation to operate at another location, he is placed at a competitive disadvantage in operating at the new location. His competitors will have less tax to pay on the same income and can maintain a fair return on investment using a lower selling price. The same result would obtain if Mr. A sought to enter an entirely unrelated field.

It is unquestioned that important business reasons exist for the operation of multiple corporations: limiting new venture capital to a set amount and protecting the capital of the original business from exposure to excess losses; limiting tort liability in the same way; permitting managerial incentive through stock participation in the operating unit; permitting labor and general business practice to conform easily to local standards. A corporation pursuing sound business and management objectives, via the multiple corporate route, would be paying a tax penalty under the proposed amendment. This is true for the smaller as well as the larger controlled group.

The independent operation of retail outlets, whether part of a regional or national chain, have as much need for individual corporate status as business in a small controlled group. Each store requires competent management and appropriate incentives. The economic success of each store is determined by its local competitive position. Once again there should be tax equality between two competitors selling the same products in the same area. Changing the tax "cost", because of the legalism of ownership, upsets the free market balance and creates inequity rather than reform.

APPROVE § 412—Installment method

The formula contained in existing law to avoid the arbitrary allocation of installment payments between return of principal and profit has proved to be equitable. We disapprove of the way in which the provision has been literally read and applied to situations that are not true installment sales.

We support the proposed amendment which restricts the installment provision to sales in which payments are actually made periodically. The treatment of a readily marketable debenture as a cash equivalent accords with generally accepted concepts, and should be approved.

DISAPPROVE § 413—Original issue discount on bonds etc.

Objection is raised to this proposed change both on the theory advanced as well as the practical application of the amendment. There is no inherent virtue in parallel tax treatment between individuals and corporations. Attempting to assert parallelism as an objective that is preferable to maintaining the integrity of the cash and accrual accounting methods is to embark on a course of independent special tax rules that contravene existing accounting principles. The wisdom of further divergence of tax principles from accounting principles is questionable but totally unnecessary in the absence of a favorable revenue change. No revenue change is expected from this amendment.

The Report of the Ways and Means Committee observed that there is no basis for maintaining the current treatment of original issue discount. Overlooked is the fact that the earned discount on the retained bond is similar to be appreciation on a capital asset. Until the time of redemption or sale the taxpayer has nothing more in hand than an evidence of debt (ownership if it were stock) and no taxable event has occurred to fix the time or amount of income. What is the equitable tax treatment when the market value of the bond declines more than the amount of the "earned discount? It can't be paying tax on the later and having no deduction for the former, but that's what would happen under this amendment.

The extremely complex nature of the computations which will be required of bondholders, especially holders other than the original owner, will cause hardship and result in an unjustified recordkeeping expense. The burdensome administrative expense which enforcement would demand is avoided by shifting it to the issuing corporation. This situation provides no justification for saddling corporations with the costs of additional recordkeeping and preparing and mailing thousands of information returns.

Disapprove § 144 Limitation on deduction of bond premium upon repurchase

The proposed treatment of the premium paid upon repurchase of a convertible indebtedness does not sufficiently clarify the current situation. It limits deductibility to a "normal call premium" on non-convertible bonds except when the corporation demonstrates that a larger premium was paid as a cost of borrowing. This allegedly provides the flexibility necessary to take into account market and credit conditions. In effect it provides that unless the corporation and the Service agree upon the deduction, they can litigate the issue, and this hardly qualifies as tax reform.

This provision continues the practice of setting a value on the conversion feature of a convertible debenture which is issued for a price above par while denying any value to such feature on a bond issued at par or at a discount. Since such treatment is not consistent it should not be extended.

Approve § 421—Stock dividends

This proposed amendment to the existing provisions of law dealing with stock dividends is necessary to carry out the section's intended purpose. It frustrates the tendency to resort to complex financing and tax maneuvers in an effort to avoid the existing statutory provision. We approve of this amendment and the principle that receiving a proportionately increased stock interest in lieu of cash is taxable as equivalent to a cash distribution.

Disapprove § 461—Increase alternative capital gains rate for corporations

This provision simply raises corporate income taxes and has no relationship to anything akin to "reform". As a higher tax levy it is unwararnted and constitutes an ill-conceived method to assist in balancing the politically expedient individual rate reductions.

The reasoning advanced for this provision is specious. It is said that having proposed an increase in individual capital gains, corporations should be taxed similarly. It would be equally valid to suggest that corporations be allowed to include one-half their capital gain in income subject to tax at a 48% rate. There are many places in the Code where individuals and corporations are treated differently and trying to find parity in rates alone is neither equitable nor economically realistic.

It is also suggested that capital gains for a corporation is essentially the same as ordinary business income. This just is not true. The sale by a manufacturing company of a minority stock interest in another corporation is the sale of a capital asset and bears no relationship to the ordinary income derived from manufacturing.

Disapprove § 515—Total distribution from qualified pension etc. plans

The existing treatment of lump-sum distributions from qualified plans encourages an employee to take his capital on retirement and put it into a business or other investment situation. This stimulates the economy and encourages continued individual productivity.

The proposed change imposes an unnecessary hardship on retirement if an election is made to take a lump-sum payment. A more severe result is obtained when the lump-sum payment is made as a result of involuntary termination of service during normal income years. In the latter situation the extra tax burden is faced from the unenviable position of unemployment. In a case where the termination occurs after an employee receives nearly a full year's ordinary income, the amount of tax due would be substantial.

Furthermore, this section will apply to plans covering more than five million employees most of whom are not high income individuals. The tax return preparation tasks of these people will be made horrendously complicated. Moreover, many of them who have kept their savings and employer contributions in such plans to obtain capital gain treatment may, where possible, withdraw from the plans. This would be an unfortunate, and certainly an unintended, consequence of this section.

We believe the present provision works well and carries out long-range economic objectives. It should be retained. Amending the existing provision will result in strained planning techniques which, in turn, will evoke demand for tax reform.

Disapprove § 521—Depreciation of real estate

Any alleged abuse in the use of accelerated depreciation should be corrected, but the proposed amendment does not constitute reasonable remedial legislation. It eviserates the construction industry and in the process creates unintended hardship for all business.

The currently allowable depreciation rates have been a strong stimulus for new construction. To the extend that it remains available for residential housing it will continue to spur new building. The proposed restrictions, in the light of current mortgage conditions, would further curtail modernization of manufacturing facilities. The lack of ready mortgage money has already forced business to either postpone new plant construction or provide a greater portion of the required capital. This setback in modernization comes at a time when rising labor costs are squeezing profit margins and pressing price levels. Only through modernization has industry managed to compensate for higher unit costs and hold down price increases. We see no justification for discouraging modernization, which will occur if business cannot take accelerated depreciation and retrieve badly needed investment capital.

The proposal will also increase the cost of commercial rental space and, in turn, add to the cost of doing business. The net short-term result of this provision is inflationary and contrary to current objectives. We urge that the status quo be maintained at this time.

Approve §§ 801–804—Tax relief provisions

These four sections of the bill afford tax relief in a variety of ways but the relief proposed is actually a tax reduction. As previously stated, we support the proposed reductions but do not believe that our present inflationary economy or our budgetary problems permit such reductions at this time. If any priority is to be given to some of these proposals our attention would focus on the low-income allowance formula and the maximum rate on earned income. The former would bring taxable income above the poverty level and set a realistic minimum level for levying an income tax. The latter corrects the confiscatory nature of our present graduated system and thus relieves the constant pressure for tax gimmickry. Both go a long way toward achieving greater equity in our tax law.

We urge the enactment of these provisions as soon as such legislation can be reconciled with our fiscal policy and a balanced budget.

Disapprove of all provisions having retroactive application

A number of proposed provisions will apply to investments made and transactions concluded prior to the time that H.R. 13270 was introduced. The tax effects considered at the time these transactions were undertaken were reasonably based on the then existing law. Taxpayers have a right to enter into long-range business and investment plans that offer a calculated return. Predictability of action based on existing law is one of the basic principles sustaining the integrity of our system of laws. It is unfair to change the results of irrevocable contracts etc. by changing the treatment of existing income or deductions. Although this is generally recognized, not all provisions of the present bill limit their impact to prospective events.

We urge that equity requires all amendments of existing law to be limited in their application to taxable events and conditions which occur after the date of enactment.

CONCLUSION

No inference is to be drawn from the fact that certain provisions of H.R. 13270 have not been discussed in the foregoing remarks. The extensive nature of the proposed changes exceeded our ability to do a complete analysis of the entire bill. Our efforts were limited to those provisions having the greatest effect on the majority of our diversified membership.

We trust that this Committee will report a tax reform bill that will benefit the national economy and neither attempt to provide short-lived advantages for individual taxpayers nor penalize the business and investment community. The prosperity of our nation cannot be fragmented. We expect legislation that will preserve a free enterprise system and foster the economic and social development of this nation for the good of all our citizens.

Senator BYRD. The next witness will be Arthur J. Packard, Chairman of the American Hotel and Motel Association Governmental Affairs Committee.

Mr. Packard, we will now hear from you, sir.

STATEMENT OF ARTHUR J. PACKARD, CHAIRMAN, GOVERNMENTAL AFFAIRS COMMITTEE, AMERICAN HOTEL & MOTEL ASSOCIATION, ACCOMPANIED BY PAUL F. WOLFE

Mr. PACKARD. For the record, if you please, I am Arthur Packard, the president of the Packard Hotel Co. and the chairman of the Governmental Affairs Committee of the American Hotel & Motel Association.

Also, for the record, the association is a federation of hotel and motel associations located in the 50 States and the Virgin Islands, Puerto Rico, District of Columbia. We represent about 7,000 hotels and motels and about 800,000 rooms. We maintain offices in Washington at 777 14th Street, and in New York at 221 West 57th Street.

I am accompanied—my colleague is Mr. Paul V. Wolfe of the national hotel and motel accounting firm of Harris, Kirk, Foster, and Co., who will summarize and present the views of the association on the tax areas important to the hotel-motel industry, and which are part of these tax reform hearings.

With your indulgence, Mr. Wolfe.

Mr. WOLFE. Thank you, Mr. Packard.

At the outset, gentlemen, I want to express my deep thanks and appreciation for this opportunity to address you briefly concerning this tax reform bill. There is a full statement that we have submitted and I will try within the time limit to cover in a highlight way the observations I would like to make in behalf of the industry.

First, with respect to the proposed increase in corporate alternate capital gains rates from the present 25 percent to 30 percent. The American Hotel & Motel Association feels that this proposed change under section 461 of the bill should be deleted because it is grossly unfair.

Corporations having taxable income are taxed thereon and the same income is taxed again to its stockholders as dividends at normal tax rates. It can therefore be seen that the beneficial owners of a corporation, that is, the stockholders, are taxed twice on the same income. Where a corporation realizes a capital gain, and pays tax thereon at corporate gains rates, such gain when distributed to stockholders as an ordinary dividend is taxed again at normal tax rates.

For this reason we feel there is enough of an imposition already imposed upon corporations with regard to capital gains and we do not feel as though it should be extended any further under the proposed bill.

Second, with regard to the retention of alternative methods of depreciation provided in section 167 of the Internal Revenue Code, section 521 of H.R. 13270 proposes changes in the use of the accelerated methods of depreciation. These proposed changes are objectionable for the reason that they are unrealistic.

While section 521 of the proposed bill allows use of the 150-percent declining balance method on new construction of hotel and motel properties, older properties purchased do not share such treatment, yet the depreciable factors remain the same. There is a difference, however, between the depreciation on newly constructed properties as compared with used properties purchased. It is a fact that more depreciation occurs in the case of newly constructed properties than in used properties during the early years of their useful lives.

This fact has been recognized by the provisions of section 167 of the code which permits the 200-percent declining balance and the sum-of-the-year digits methods, in the case of newly constructed properties and a maximum of 150-percent declining balance method for used properties, and these provisions should be maintained.

Retention of present rules regarding recaptured depreciation as provided in section 1250 of the Internal Revenue Code:

Another part of section 521 of H.R. 13270 provides for a tax at ordinary rates on any gain realized on the disposition of depreciable real property to the extent of the excess of depreciation claimed on any accelerated method over the amount of depreciation which would be allowed computed on the straight-line method with respect to depreciation to taxable years ending after July 24, 1969.

No matter how long a depreciable asset has been used in trade or business, no consideration is given to the fact which inflation plays in fixing the selling price of an asset. As a consequence, income tax is imposed on the increase in value due to inflation, with the result that the asset disposed of cannot be replaced with an asset of equal value without borrowing funds to replace the income tax paid.

The current law gives some effect to the inflationary aspect of the economy. It is respectfully submitted that to convert what would in whole or in part be presently taxed as capital gains into ordinary income to individuals and taxed to them at their highest surtax bracket is drastic and excessively burdensome. Since the beneficial owners of corporations, that is, the stockholders, in effect pay double taxes, to convert the corporate gain from capital gain status to ordinary income tax classification is equally offensive.

Effect of earnings and profits of depreciation:

The association is opposed to section 452 of H.R. 13270 dealing with the effect on earnings and profits of accelerated depreciation on the basis that is introduced a double standard (1) for the determination of taxable net income, and (2) for the computation of earnings and profits.

It is submitted that when depreciation is computed in accordance with the provisions of the law, such depreciation equates that which is proper, reasonable, and just; otherwise, such depreciation method should not be allowed in the first instance. If depreciation is considered correct, and recognized in the determination of net income to be taxed, then such depreciation should be accepted in computing earnings and profits.

Elimination of multiple surtax corporate tax exceptions and other benefits:

The Association objects to the provisions of section 401 of H.R. 13270 which would eliminate the multiple corporate surtax exemption and other related benefits and such objection is on the broad basis of inequality.

Section 401 of the bill discriminates among taxpayers. This observation is predicated on the fact that two or more separate business activities owned by different interests will pay less income tax than if the same business were owned by common control. It is clear, therefore, that a penalty is being imposed on a multiplicity of business activities which cannot only be labeled as repressive and discriminatory. There should be no tax penalty imposed upon the business community in conducting business activities in a multiplicity of corporate forms that are found essential and desirable in the ordinary course of business.

All members of the community should be given an equal opportunity to conduct their business activities in a corporate setup found to be desirable and competitive without being penalized for doing so by our tax laws.

Unrelated business tax sections 511 and 513 of the I.R.C.:

We are in general agreement with the provisions contained in section 121 of H.R. 13270 which would extend the "unrelated business income tax" to virtually all exempt organizations and would also impose a tax on the investment income of such organizations. We request, however, that the bill be amended so as to exclude from "unrelated trade or business" the activities of a trade show sponsored by a business league coming under section 501 (c) (6).

The final IRS regulations regarding certain activities of 501 (c) (6) organizations, as issued on December 12, 1967, and section 278 (c) of the bill would seem to imply that a trade show of a type common to the hotel/motel industry represented an "unrelated trade or business," as defined in section 513, and that the gross income derived therefrom was taxable as "unrelated business income" as provided for in section 511.

In Rev. Rul. 67-219 and the regulations, the IRS takes the position that income from trade shows is not unrelated income where the exhibits are for products or services utilized by the sponsoring organization's members.

We respectfully wish to point out that if the IRS approves of trade shows at which individual members of a tax-exempt business league display their products to their potential customers, then surely the display at an industry trade show by suppliers of products used in the industry is within the activities and purposes of the industry's business league.

It is, therefore, requested that section 513(a) of the Internal Revenue Code be amended to exclude from the category of unrelated trade or business the conduct of a trade show sponsored by a business league exempt from tax under 501(c)(6).

That completes my prepared statement.

Senator BYRD. Thank you, sir.

Senator Williams? Senator Bennett? Senator Curtis?

Senator CURTIS. One question.

In regard to recapturing, I believe that my memory is correct that some of the builders and the owners of real property have previously testified that if that is to be imposed, it should not be impoesd if the property was held for a reasonable period of years. Apparently directing the impact of change more on the in-and-outer rather than the investor or operator of a business who intends to say for sometime.

Do you have any comment on that?

Mr. WOLFE. Well, this is a special perhaps comment or consideration that they have given it with respect to the building industry. Of course our comments have been directed primarily to hotels and motels which are long-term investors in property. We think that the present bill is sufficient to take care of it, and to convert the recapture and depreciation now into ordinary income tax is grossly repressive.

Senator CURTIS. You think the present law, not the present bill?

Mr. WOLFE. That is right, the present law we feel is all right as far as we are concerned.

Senator CURTIS. That is all I have, Mr. Chairman.

Senator BYRD. Thank you, Mr. Packard and Mr. Wolfe.

Mr. WOLFE. Thank you.

(The prepared statement of the Hotel and Motel Association follows:)

STATEMENT OF AMERICAN HOTEL AND MOTEL ASSOCIATION

SUMMARY

Proposed increase in corporate alternate capital gains rates from the present 25 percent to 30 percent

The American Hotel & Motel Association contends that the proposed change under Section 461 of H.R. 13270 should be deleted because it is grossly unfair. Corporations having taxable income are taxed thereon and the same income is taxed again to its stockholders as dividends at normal tax rates. It can therefore be seen that the beneficial owners of a corporation, i.e., the stockholders, are taxed twice on the same income. Where a corporation realizes a capital gain, and pays tax thereon at corporate gains rates, such gain when distributed to stockholders as an ordinary dividend is taxed again at normal tax rates.

Retention of alternative methods of depreciation provided in section 167 of the Internal Revenue Code

Section 521 of H.R. 13270 proposes changes in the use of the accelerated methods of depreciation. These proposed changes are objectionable for the reason that they are unrealistic.

While Section 521 of the proposed bill allows use of the 150 percent declining balance method on new construction of hotel and motel properties, older properties purchased do not share such treatment, yet the depreciable factors remain the same. There is a difference, however, between the depreciation on newly constructed properties as compared with used properties purchased. It is a fact that more depreciation occurs in the case of newly constructed properties than in used properties during the early years of their useful lives. This fact has been recognized by the provisions of Section 167 of the Code which permits the 200 percent declining balance and the sum-of-the-year digits methods, in the case of newly constructed properties and a maximum of 150 percent declining balance method for used properties, and these provisions should be maintained.

RETENTION OF PRESENT RULES REGARDING RECAPTURED DEPRECIATION AS PROVIDED IN SECTION 1250 OF THE INTERNAL REVENUE CODE

Another part of Section 521 of H.R. 13270 provides for a tax at ordinary rates on any gain realized on the disposition of depreciable real property to the extent of the excess of depreciation claimed on any accelerated method over the amount of depreciation which would be allowed computed on a straight-line method with respect to depreciation applicable to taxable years ending after July 24, 1969.

No matter how long a depreciable asset has been used in trade or business, no consideration is given to the part which inflation plays in fixing the selling price of an asset. As a consequence, income tax is imposed on the increase in value due to inflation, with the result that the asset disposed of cannot be replaced with an asset of equal value without borrowing funds to replace the income tax paid.

The current law gives some effect to the inflationary aspect of the economy. It is respectfully submitted that to convert what would in whole or in part be presently taxed as capital gains into ordinary income to individuals and taxed to them at their highest surtax bracket is drastic and excessively burdensome. Since the beneficial owners of corporations, i.e., the stockholders, in effect pay double taxes, to convert the corporate gain from capital gain status to ordinary income tax classifications is equally offensive.

EFFECT ON EARNINGS AND PROFITS OF DEPRECIATION

The Association is opposed to Section 452 of H.R. 13270 dealing with the effect on earnings and profits of accelerated depreciation on the basis that it introduced a double standard (1) for the determination of taxable net income, and (2) for the computation of earnings and profits.

It is submitted that when depreciation is computed in accordance with the provisions of the law, such depreciation equates that which is proper, reasonable and just; otherwise, such depreciation method should not be allowed in the first instance. If depreciation is considered correct, and recognized in the determination of net income to be taxed, then such depreciation should be accepted in computing earnings and profits.

ELIMINATION OF MULTIPLE SURTAX CORPORATE TAX EXEMPTIONS AND OTHER BENEFITS

The Association objects to the provisions of Section 401 of H.R. 13270 which would eliminate the multiple corporate surtax exemption and other related benefits and such objection is on the broad basis of inequality.

Section 401 of the bill discriminates among taxpayers. This observation is predicated on the fact that two or more separate business activities owned by different interests will pay less income tax than if the same business were owned by common control. It is clear, therefore, that a penalty is being imposed on a multiplicity of business activities which can only be labeled as repressive and discriminatory.

There should be no tax penalty imposed upon the business community in conducting business activities in a multiplicity of corporate forms that are found essential and desirable in the ordinary course of business. All members of the community should be given an equal opportunity to conduct their business activities in a corporate setup found to be desirable and competitive without being penalized for doing so by our tax laws.

UNRELATED BUSINESS TAX SECTIONS 511 AND 513 OF THE I.R.C.

We are in general agreement with the provisions contained in Section 121 of H.R. 13270 which would extend the "unrelated business income tax" to virtually all exempt organizations and would also impose a tax on the investment income of such organizations. We request, however, that the bill be amended so as to exclude from "unrelated trade or business" the activities of a trade show sponsored by a business league coming under Section 501(c)(6).

The final I.R.S. regulations regarding certain activities of 501(c)(6) organizations, as issued on December 12, 1967, and Section 278(c) of the bill would seem to imply that a trade show of a type common to the hotel/motel industry represented an "unrelated trade or business," as defined in Section 513, and that the gross income derived therefrom was taxable as "unrelated business income" as provided for in Section 511.

In Rev. Rul. 67-219 and the regulations, the I.R.S. takes the position that income from trade shows is not unrelated income where the exhibits are for products or services utilized by the sponsoring organization's members. We respectfully wish to point out that if the I.R.S. approves of trade shows at which individual members of a tax-exempt business league display *their* products to *their* potential customers, then surely the display at an industry trade show by suppliers of products used in the industry is within the activities and purposes of the industry's business league.

It is, therefore, requested that Section 513(a) of the I.R.C. be amended to exclude from the category of "unrelated trade or business" the conduct of a trade show sponsored by a business league exempt from tax under 501(c)(6).

STATEMENT

I am Arthur J. Packard, President of the Packard Hotel Company and Chairman of the Governmental Affairs Committee of the American Hotel & Motel Association.

The Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico, and the Virgin Islands having a membership in excess of 6,800 hotels and motels containing in excess of 750,000 rentable rooms. The American Hotel & Motel Association maintains offices at 221 West 57th Street, New York, New York, and at 777 14th Street, N.W., Washington, D.C.

I am accompanied by Mr. Paul V. Wolfe of the national hotel and motel accounting firm of Harris, Kerr, Forster & Company, who will testify on behalf of the Association on tax areas important to the hotel/motel industry which are a part of these tax reform hearings.

My name is Paul V. Wolfe, a partner in the national accounting firm of Harris, Kerr, Forster & Company, which is headquartered at 420 Lexington Avenue in New York City.

I am appearing today on behalf of the American Hotel & Motel Association to testify on portions of H.R. 13270 which are of primary interest to the Association.

GENERAL COMMENTS REGARDING HOTELS AND MOTELS

In considering the comments I am going to make regarding the taxation of capital gains and accelerated depreciation, I feel it is important to have in mind that hotels and motels are required to invest very substantial sums in land, structures and equipment and they actually operate a business. They are not passive investors. In addition, they employ vast numbers of unskilled and semi-skilled help consisting of maids, bellboys, waiters, maintenance personnel and similar service employees. Hotels and motels, besides being a very important segment of our social and business community, play a very important role as host to foreign travelers in our country. This role of host to foreign travelers will be stepped up very substantially in the near future by reason of the fact there is on the horizon mass inter-continental transportation due to the construction of larger jet planes. In view of this observation it can be expected that hotels and motels should be encouraged to fulfill their destined role as a contributor to the improvement of our balance of payments program.

PROPOSED INCREASE IN CORPORATE ALTERNATE CAPITAL GAINS RATES FROM THE PRESENT 25 PERCENT TO 30 PERCENT

The American Hotel & Motel Association contends that the proposed change under Section 461 of H.R. 13270 is grossly unfair to corporations. It must be borne in mind that corporations having taxable income are taxed thereon and that the same income is taxed again to its stockholders as dividends at normal tax rates. It can therefore be seen that the beneficial owners of a corporation, i.e., the stockholders, are taxed twice on the same income. Where a corporation realizes a capital gain, and pays tax thereon at corporate gains rates, such gain when distributed to stockholders as an ordinary dividend is taxed again at normal tax rates.

One of the reasons given for the increase in the alternate capital gains rates from 25 percent to 30 percent is the alternate capital gains tax for individuals is being eliminated. It is submitted that the alternate capital gains rate on individuals and corporations are not opposite since as pointed out above corporate capital gains are taxed twice whereas individual capital gains are taxed once.

By reason of the foregoing analysis, it is felt that the changes in the corporate alternate capital gains tax proposed in Section 461 should be eliminated, and that the present tax provisions of our Code dealing with alternate corporate capital gains rates should be retained.

RETENTION OF ALTERNATIVE METHODS OF DEPRECIATION PROVIDED IN SECTION 167 OF THE INTERNAL REVENUE CODE

Section 521 of H.R. 13270 proposes changes in the use of the accelerated methods of depreciation. These proposed changes are considered by the American Hotel & Motel Association to be objectionable for the reason that they are unrealistic and unfair. With respect to proposed changes in the use of the 200 percent declining balance and sum-of-the-years digits method contained in Section 167 of the I.R.C., it is desired to highlight the observation that these methods are economically sound and factually realistic.

The purpose of depreciation is to allow a taxpayer to recoup its tax basis over its economic useful life. It is a fact that an asset depreciates more in the earlier years of its useful life and less in later years. Repairs are less in the earlier years of the life of an asset and increase at an accelerated rate as the asset gets older. Accelerated depreciation, therefore, gives effect to physical realities and results in equalizing charges against income over the useful life of a depreciable asset. This result is accomplished by a larger write-off for depreciation with small repair incidents in earlier years and larger repairs and smaller depreciation as useful life progresses.

While Section 521 of the proposed bill allows use of the 150 percent declining balance method on new construction of hotel and motel properties, older properties purchased do not share such treatment, yet the depreciable factors remain the same. There is a difference, however, between the depreciation on newly constructed properties as compared with used properties purchased. It is a fact that more depreciation occurs in the case of newly constructed properties than in used properties during the early years of their useful lives. This fact has been recognized by the provisions of Section 167 of the Code which permits the use of the 200 percent declining balance and the sum-of-the-years digits method in the case of newly constructed properties and a maximum of 150 percent declining balance method for used properties.

Factually, it would be unjust and improper to cut down the present permissible rates on newly constructed hotel and motel properties from the 200 percent declining balance method or the sum-of-the-years digits method to the 150 percent declining balance method and to also cut down the present rate of depreciation on used properties from the 150 percent declining balance method to the straightline method. The changes proposed in the permissible use of accelerated methods of depreciation would be completely at variance with the true loss of economic value in the form of depreciation in computing taxable net income.

The retention of the present allowable 200 percent declining balance and the sum-of-the-years digits method enables business organizations to repay their loans quicker, thereby reducing interest expense. In addition, the presently allowed accelerated methods help hotel and motel industries to cope to some extent with inflationary costs. This is accompanied by an earlier larger cash throwoff being payable through the use of such methods.

In view of the foregoing, it is requested that Secton 167 of the Internal Revenue Code be left unrevised.

RETENTION OF PRESENT RULES REGARDING RECAPTURED DEPRECIATION AS PROVIDED IN SECTION 1250 OF THE INTERNAL REVENUE CODE

Another part of Secton 521 of H.R. 13270 provides for a tax at ordinary rates on any gain realized on the disposition of depreciable real property to the extent of the excess of depreciation claimed on any accelerated method over the amount of depreciation which would be allowed computed on a straight-line method with respect to depreciation applicable to taxable years after July 24, 1969.

The American Hotel & Motel Association is firm in its opinion, under our present inflated economy, that any gain realized on the disposition of hotel and motel properties should not be taxed at all, but feels that if a tax must be imposed, the tax provision of the present law should be retained and applied.

On the sale or taxable exchange of depreciable assest, gain or loss is computed on the difference between adjusted tax cost and the sales price. Adjusted tax cost is origininal cost less depreciation allowed or allowable. No matter how long a depreciable asset has been used in trade or business, no consideration is given to the part which inflation plays in fixing the selling price of an asset. As a consequence, income tax is imposed on the increase in value due to inflation, with the result that the asset disposed of cannot be replaced with an asset of equal value without borrowing funds to replace the income tax paid.

The current law gives effect to the inflationary aspect commented upon by giving some relief at capital gains rates on the gain realized on the sale of depreciable real estate held over 20 months on declining rates with full capital gains tax on profits derived from the sale of such assets held more than 10 years.

It is respectfully submitted that to convert what would in whole or in part be presently taxed at capital gains rates into ordinary income to individuals and taxed to them at their highest surtax bracket is drastic and excessively burdensome. Since the beneficial owners of corporations, i.e., the stockholders, in effect pay double taxes, to convert the corporate gain from capital gain status to ordinary income tax classification is equally offensive.

In view of the foregoing, it is recommended that the present provisions of Section 1250 of the I.R.C. be retained as presently constituted.

EFFECT ON EARNINGS AND PROFITS OF DEPRECIATION

The Association is opposed to Section 452 of H.R. 13270 dealing with the effect on earnings and profits of accelerated depreciation on the basis that it introduces a double standard (1) for the determination of taxable net income, and (2) for the computation of earnings and profits.

It is submitted that when depreciation is computed in accordance with the provisions of the law, such depreciation equates that which is proper, reasonable and just; otherwise, such depreciation method should not be allowed in the first instance. If depreciation is considered correct, and recognized in the determination of net income to be taxed, then such depreciation should be accepted in computing earnings and profits. For the reasons stated, it is urged that Section 452 of the proposed bill be deleted.

ELIMINATION OF MULTIPLE CORPORATE SURTAX EXEMPTIONS AND OTHER BENEFITS

The Association desires to express its objection to the provisions of Section 401 of H.R. 13270 which would eliminate the multiple corporate surtax exemption and other related benefits and such objection is on the broad basis of inequality.

Presently, in order to obtain a mutiple surtax exemption, an election must be made by each member of a controlled group of corporations. As a consequence of this election, each corporation in the controlled group is required to pay an added 6 percent tax on the first $25,000 of their taxable net income pursuant to Section 1562 of the Internal Revenue Code. This privilege carries with it other concomitant benefits which are propsed to be eliminated together with the multiple surtax exemption under the proposed bill.

It is submitted that Section 401 of the bill discriminates among taxpayers. This observation is predicated on the fact that two or more separate business activities owned by different interests will pay less income tax than if the same business were owned by common control. It is clear, therefore, that a penalty is being imposed on a multiplicity of business activities which can only be labeled as repressive and discriminatory. There should be no tax penalty imposed upon the business community in conducting business activities in a multiplicity of corporate forms that are found essential and desirable in the ordinary course of business. All members of the community should be given an equal opportunity to conduct their business activities in a corporate setup found to be desirable and competitive without being penalized for doing so by our tax laws. The provisions of Section 401 would have that effect. All members of the business community should be given an opportunity to expand and diversify their business activities without being hampered by penalty taxation.

UNRELATED BUSINESS TAX SECTIONS 511 AND 513 OF THE IRC

We are in general agreement with the provisions contained in Section 121 of H.R. 13270 which would extend the "unrelated business income tax" to virtually all exempt organizations and would also impose a tax on the investment income of such organizations. We request, however, that the bill be amended so as to exclude from "unrelated trade or business" the activities of a trade show sponsored by Section 501(c)(6) organizations.

(*a*) *Section 511 of the I.R.C. should be extended to cover Section 501(c)(4), 501(c)(7), and 501(c)(8) organizations.*

The Association has been constantly alerted by its members to the "business" activities of various organizations which have been granted tax-exempt status. This is especially true of organizations which come under Sections 501(a) and 501(c) of the Code. Evidence of such activity is most often in the form of either public invitations from the organizations or published information of the activities after they have occurred.

It has been our regular practice to forward evidence of such "business" activity to the I.R.S. To date we have seen little curtailment of the activities which form the basis of our objections. If anything, the volume of "business" by such organizations appear to be on the increase.

Most often this activity—which we prefer to term "unfair competition"—consists of solicitations on behalf of tax-exempt organizations for the business of the general public. Organizations which have been granted a tax exemption under Sections 501(c) (4), (7) and (8) openly seek and obtain business which would otherwise be available to tax-paying hotels and motels. More specifically, civic organizations, social and recreation clubs, and fraternal beneficiary societies "open their doors to the public" in the solicitations of lodging and food service business.

Under the provisions of the Code and the regulations thereto, Section 501(c)(4), civic organizations, must be neither organized nor operated for profit; Section 501(c)(7), social and recreation clubs, must be organized and operated exclusively for pleasure, recreation and other non-profitable purposes and must not make their facilities available to the public; and Section 501(c)(8), fraternal beneficiary societies, must be operated in furtherance of their fraternal purposes and may not engage in business activities of a kind carried on with nonmembers for a profit.

In 1964 the I.R.S. issued Revenue Procedure 64–36 regarding certain activities of Section 501(c)(7), social and recreation clubs. In these so-called "guidelines" the Service stated that advertising or other solicitations for business by such organizations would be prima facie evidence that such a club is engaging in business and is not being operated exclusively "for pleasure, recreation and other non-profitable purposes." This portion of the guidelines merely reiterated past I.R.S. regulations.

The guidelines further stated that 501(c)(7) organizations would be allowed annual gross receipts from business activities of $2500 or less without jeopardizing its exemption. Where such receipts exceeded $2500, they must have been 5 percent or more of the organization's total receipts before tax-exempt status would be jeopardized. The guideline further noted that member sponsorship arrangements would not circumvent the gross receipt limitation. If the organization's members constituted less than 75 percent of the total number of persons utilizing the organization's facilities on a particular occasion, all of the receipts received therefrom would be considered nonmember receipts unless the organization can properly apportion such receipts between members and nonmembers.

Revenue Procedure 64–36 appears on the surface to be a recognition by the I.R.S. that 501(c)(7) organizations do, in fact, often extend their activities to those who are outside their membership and their guests. We submit that Revenue Procedure 64–36 has not deterred such activities which are in addition to a club's purpose and are, therefore, unrelated and should be taxed as such.

In view of the similarity in both the manner in which tax-exempt status is granted to 501(c)(4) and 501(c)(8) organizations and the methods employed by such organizations in soliciting business from the general public, we request that the provisions of Section 511 of the Code be likewise extended to these organizations.

By complying with the request to have 501(c)(4), 501(c)(7) and 501(c)(8) organizations covered by Section 511 of the Code, such organizations will be contributing a proper share to the revenue from the profits realized on activities that are foreign to purposes for which they were formed.

(*b*) *Section 513(a) of the I.R.C. should be amended to exclude from Unrelated Trade or Business the Activities of a Trade Show Sponsored by Section 501(c)(6) Organizations.*

The final I.R.S. regulations regarding certain activities of 501(c)(6) organizations, as issued on December 12, 1967, *implied* that a trade show of a type common to the hotel/motel industry represented an "unrelated trade or business," as defined in Section 513, and that the gross income derived therefrom was taxable as "unrelated business income" as provided for in Section 511.

Numerous regional, state or city hotel and motel associations sponsor a trade show no more than once a year. Space is assigned to various exhibitors desirous of participating, for which they pay a consideration. There are numerous exhibitors at the show whose products are normally used in hotel and motel operations. Some exhibitors may sell their products or services at trade shows whereas others merely display or advertise their wares. No hotels or motels participate in these trade shows as exhibitors.

Normally, these trade shows are held at the time of the year when there is an annual meeting of the membership, i.e., when the members gather to discuss the affairs of the association, lay out future programs of the association, have quest lecturers on subjects of hotel/motel interest and business promotion, and elect officers. In short, at the annual meetings, there are many programs presented representing a common interest to the members of the association. In view of the fact that the members meet annually, it is felt a most appropriate time to infuse into such meetings a program of education for the membership, as well as to call to their attention the developments in various fields relating to the products which they use in the conduct of their hotel or motel business; hence, the trade show.

It can, therefore, be seen that these trade shows are an essential and integral part of the purpose for which the state and city associations have been formed. Through the trade shows the overall economy of a multitude of different types of businesses are represented and in the this regard there is no isolated interest in one particular industry, but a wide divergency of industry activity and services. Through the means of such trade shows the membership of the various state or city hotel and motel associations are kept abreast of the improvements in various industries that are essential to their operations and an integral part of our national economy.

At such trade shows the public is generally not admitted, and it is only in an exceptional case, where there is some relationship to a hotel or motel activity, that a member of the general public may be admitted. The membership of the hotel or motel association that sponsors the trade show normally pay a registration fee to attend the annual meeting and its auxiliary activities include the trade show.

It is submitted that the foregoing described activities fall directly within those permitted a trade association which is exempt from income tax per Section 501 (c) (6). Such a trade show is clearly not the conduct of an "unrelated trade or business" within the meaning of Section 513. The receipts from such an activity should be clearly exempt from the tax on "unrelated business income" imposed by Section 511.

In Rev. Rul. 67-219 and the regulations, the I.R.S. takes the position that income from trade shows is not unrelated income where the exhibits are for products or services utilized by the sponsoring organization's members. We respectfully wish to point out that if the I.R.S. approves of trade shows at which individual members of a tax-exempt business league display *their* products to *their* potential customers, then surely the display at an industry trade show by suppliers of products used in the industry is within the activities and purposes of the industry's business league.

Trade shows sponsored by Section 501(c) (6) organizations for the purpose of enabling their members to keep up with current product and service development all toward making more efficient and profitable the member's business activities is one of the universal purposes of Section 501(c) (6) organizations. In view of this fact, all trade show activities so sponsored and conducted should be classified as related to the purposes and objectives of such organizations and any income realized from such trade shows so classified.

It is, therefore, requested that Section 513(a) of the I.P.C. be amended to exclude from the category of "unrelated trade or business" the conduct of a trade show sponsored by a business league exempt from tax under 501(c) (6).

Senator BYRD. The next witness will be Carl A. Beck, who is chairman of the board of trustees, National Small Business Association.

STATEMENT OF CARL A. BECK, CHAIRMAN OF THE BOARD OF TRUSTEES, NATIONAL SMALL BUSINESS ASSOCIATION; ACCOMPANIED BY JOHN L. KILCULLEN, COUNSEL FOR CONFERENCE OF AMERICAN SMALL BUSINESS ORGANIZATIONS, CHICAGO, ILL.

Mr. BECK. Good morning.

My name is Carl A. Beck. I am chairman of the board of trustees of the National Small Business Association representing some 35,000 small businesses of the United States.

I am also president of the Charles Beck Machine Corp. of King of Prussia, Pa., and I am therefore a small businessman myself (the adjective small, of course, refers to the business—not to the businessman).

In furtherance of the committee's request for maximum consolidation of testimony, with me today is Mr. John L. Kilcullen, counsel for the Congress of American Small Business Organizations, headquartered in Chicago, also representing some 35,000 small businesses which organization would like to join with us in support of the five points that we are making, relative to corporate tax rates.

I would like to congratulate the committee on its businesslike method of receiving testimony, and in accordance with your request I will confine my few remarks to a summary of the five basic points which are amplified in the statement which we have submitted.

I would like to call to your attention, first, to our innate conviction and concurrence in the need for fiscal soundness. The items we are suggesting for consideration, taken together, should not reduce Federal revenues, but will, on the contrary, significantly increase the total amount of Federal receipts.

Secondly, we were disappointed to read in section 452 of the proposal that all businesses—other than farming—be forced to use straight-line depreciation methods. Ever since the Revenue Act of 1962 we have been trying to encourage the Internal Revenue Service to establish workable and permanent guidelines for depreciation.

This proposal in H.R. 13270 obviously would eliminate the need for such guidelines—and this then becomes a matter of throwing out the baby with the bath water. Flexibility of depreciation methods is extremely important to the small businessman. In a small- or medium-size company, any single investment is a large proportion of his total assets—he cannot buy 10 percent of a lathe or one-half of a milling machine, regardless of how small his incremental needs may be.

The large company, on the other hand, having an on-going program of annual purchase of tens, or hundreds of even thousands of machine tools, has a resulting depreciation schedule which tends to remain relatively constant, year to year.

In addition, technological advancement, particularly in manufacturing, demands increasing expenditure for tooling, well beyond what was required two or three decades ago, if business is to remain competitive today. Up until now a company has had the choice of accelerated depreciation or obtaining the investment tax credit. Under the proposed bill they will have neither.

At yesterday's hearings one of the witnesses was questioned about his unfortunate use of the words "breach of faith," and if we are to assume that the investment tax credit, which at enactment was to be permanent, and after suspension and reinstatement was again meant to be a permanent part of the tax structure (not to be "handled like a yo-yo," as someone said), if indeed the investment tax credit is again to be lost, then the matter of depreciation options becomes doubly important to the small business economy.

The next item is in reference to section 121, relative to the taxation of currently tax-exempt, profit making businesses. The extreme unfairness of past practices was vividly brought to our attention by one of our own trustees, who showed us an offer made to him, whereby a church would buy his business, totally with the tax dollars which were not paid to the Federal Government, and as they outlined in great detail, with substantial monetary gains to both the church and the small business present owner.

We presented information on these matters when bills were before the 89th Congrss, and are happy to see that such provisions have been included in the tax bill now under consideration.

Next, we would strongly recommend that the committee consider the inclusion of section 5 of S. 2646, introduced by your committee member Senator Abraham Ribicoff, which deals with Imposition of Tax on Income of Cooperative Corporations, as an integral part of the overall tax reform program.

I call to your attention that, for over three decades, the National Small Business Association has been urging Congress to have those profit making operations, masquerading as co-ops, pay their own fair share of Federal taxes. In these days of emphasis on "equal opportunity for employees" (an admittedly sound principle) might we also encourage equal opportunity for employers?

Just as with tax-exempt profitmaking business operations referred to above, so also is it unfair that profitmaking co-ops are permitted to compete "tax free" with those businesses which are bearing their own fair share of Federal corporate taxes.

The last item that we would like to recommend for your consideration is that the level at which the corporate surtax applies, be raised from $25,000 to $100,000. As we have stated in our formal statement, the $25,000 figure goes back to the days of the "notch tax" in the 1930's, and yet we know what has happened to the value of the dollar over three or four decades.

We have investigated, to the best of our ability, the impact on Federal revenues of such proposal. In the "Statistics of Income for 1965, Corporation Income Tax Returns" published by the Internal Revenue Service, is a breakdown of corporate income by size of company. As best we can, by averaging, extrapolating, and estimating with figures available under "All Industrial Divisions" section on page 123, we have come to the following conclusions:

1. Under our proposal, 713,658 companies (we estimate) would not be affected by this proposal since their before-tax incomes are apparently under $25,000.

2. We estimate that 181,944 companies are in the income bracket of $25,000 to $100,000 before Federal income taxes, and these companies would thus have tax reduction, and hence revenue loss to the Federal Government, totaling $910 million.

3. The third group of companies, numbering 29,709 apparently have net income before taxes of more than $100,000. The revenue loss from these companies by having the normal corporate tax rate of 22 percent continuing from $25,000 to $100,000 would be $580 million.

4. The total revenue loss to the Federal Government we thus estimate to be $1,490 million for the industrial division—915,311 of 1,296,847—approximately three-quarters of all companies reporting.

To demonstrate this visually we have prepared a graph which shows present corporate income tax (the green line) change in income tax resulting from this proposal (the orange line) labeled "Increased Surtax Exemption," and change in tax through Treasury proposal (the red line), as related to income before taxes.

You will note that if a 2-percent across-the-board reduction in the corporate tax were enacted, the loss of revenues to the Federal Government would be somewhat higher, which we calculate to be $1,530 million for the industrial divisions.

This compares with the estimate of Secretary of the Treasury Kennedy of approximately $1,600 million for all corporations. However, our proposal is of benefit and potential benefit to 895,000 small- and medium-sized industries, although of little benefit to the 30,000 largest businesses in the industrial category. Similar proportions hold for the other categories of businesses.

In essence, what we are proposing is fiscal soundness, coupled with an increase in Federal revenue, through a program which provides incentives to that sector of the economy which is most disadvantaged and constrained by the economic environment of business in today's ecology.

May I emphasize that we are not asking for special dispensations, but only for an end to unfair, discriminatory treatment of the small and medium taxpaying enterprise.

Congress has continually reaffirmed the importance of small business to the economy. We appreciate this opportunity to put before you concepts which will, in a meaningful way, accomplish basic congressional objectives.

I thank you.

(Carl A. Beck's prepared statement follows:)

STATEMENT OF CARL A. BECK FOR THE NATIONAL SMALL BUSINESS ASSOCIATION

SUMMARY

1. The concept of a "normal" corporation income tax on profits of $25,000 goes back to the "Thirties." Since that time the dollar has lost almost 75% of its value. Today's technology requires proportionately larger investments by small business in plant and equipment. We believe tax equity demands that the "normal" corporate tax be applied to the first $100,000 of corporate taxable income because of (1) the depreciation of the value of money and (2) the added capital requirements of small business. The fiscal effect of increasing the level of surtax exemption from $25,000 to $100,000 is almost exactly equal to lowering the tax rate 2% on the first $1 million dollars of corporate profits.

2. Sec. 452 of H.R. 13270 restricting the use of accelerated depreciation by all corporations unduly penalizes the smaller firm. In the case of small business, investments are sporadic and any single purchase of equipment is a large percentage of the total capital invested in the business. In the case of large corporations the effect of Sec. 452 would be relatively minuscule compared with the smaller corporation. Rapid depreciation more nearly reflects the actual—and true—rate of depreciation of plant and machinery. Accelerated depreciation is vital to small business in that it allows the entrepreneur a return of capital to be reinvested thus permitting the smaller business to expand and keep modern.

3. Meaningful tax reform with respect to cooperatives is presented in S. 2646 (Ribicoff) as it places the co-ops on the same tax basis as other business enterprises, making them fully taxable on the profits which they earn. We support the provisions of S. 2646 with respect to cooperatives, and urge their substitution for Sec. 531 of H.R. 13270.

4. We support in principle, the provisions of Sec. 121 of H.R. 13270 relating to the business income of now tax-exempt organizations. Income derived by such organizations from commercial transactions in direct competition with taxpaying business should *not* be tax exempt.

5. Our proposals strengthen fiscal soundness of our nation—a basic objective of National Small Business Association—by encouraging a sound long-range build-up of a vital productive sector of our economy.

STATEMENT

Mr. Chairman and Members of the Committee:

My name is Carl A. Beck. I appear as Chairman of the Board of Trustees of National Small Business Association. I am President of the Charles Beck Machine Corporation, King of Prussia, Pa.

1. We urge that the *corporate surtax exemption be increased from $25,000 to $100,000.*

2. We recommend that Section 452 *be amended to permit the use of accelerated depreciation by small and medium-sized businesses.*

3. We endorse the *provisions of S. 2646* (Ribicoff) *with respect to cooperatives, and urge their substitution for Sec. 531 of H.R. 13270.*

4. We support, in principle, the provisions of H.R. 13270 relating to *taxation of the business income of now tax-exempt organizations.*

I. SMALL BUSINESS COMMUNITY IS BEING OVERLY PENALIZED IN PROPOSED TAX REVISION

A. *Corporate surtax exemption should be increased from $25,000 to $100,000*

Secretary of the Treasury Kennedy in his statement of September 4, 1969 to the Committee pointed out that H.R. 13270 is "weighted in favor of consumption to the potential detriment of the nation's productive investment." To his statement we would add that the detriment to the nation's productive investment would be concentrated to a large degree in the small business sector. The cumulative effect of monetary and fiscal controls with associated high interest rates, loss of the 7% investment credit, the proposed 2% increase in corporate tax rates, and the current 10% surcharge on tax rates, will be to restrict substantially investments by small business in new plant and equipment.

The competitive position of small manufacturing, wholesale and retail establishments *vis-a-vis* their big business counterparts will be adversely affected. In order to remain competitive with big business in this period of rapidly advancing technology, small business needs to modernize plant and equipment to keep pace with the giants. Incentives to investment are there—but small business must find the capital for investment either through moneys withheld in the form of profits or by borrowing. I do not think it is necessary to tell the Committee that, for all practical purposes, the credit now available to small business is both too little and too expensive. Sources of funds for small business expansion, except for money generated by the business itself, have just about dried up. SBA funds except for disaster loans and loans to minority businesses are practically non-existent at the present time. Bank loans a under 10% are all but impossible and for obvious reasons preference is given to the large borrower.

Equity financing by floating stock or bond issues in the current depressed market is not attractive because of the high premium which the small corporation must pay in brokerage fees, legal fees, high interest and low stock prices.

What is left? Reinvestment of the profits from the business.

We believe that as a matter of tax equity and long-range social and economic policy, this Committee must make an adjustment to the proposed Tax Reform Act to make it possible for small business to generate sufficient capital from income to be able to continue to make investments in new plant and equipment. "Free enterprise" in this time of economic readjustment must not be made to absorb disproportionately the government-imposed disincentives to economic growth, efficiency and modernization. We would prefer, obviously, that the 7% investment credit be retained up to say $50,000 per year, but since the Administration is determined that the investment credit be sacrificed, we most urgently recommend to the Committee that relief in the form of an adjustment to the corporate surtax structure be adopted.

The concept of giving small business preferential treatment by permitting it to retain a larger proportion of its income to be reinvested for growth is not new. The concept of a "normal" corporation income tax on profits of $25,000 or less with a surtax on corporate profits of over $25,000 goes back to the "Thirties." Since that time the dollar has lost almost 75% of its value. In addition today's technology requires proportionately larger investments by small business in plant and equipment.

Therefore, the depreciation of the value of money plus the added capital requirements of small business, argue that the surtax should not apply until the $100,000 level is reached.

We believe that in the light of the current surcharge of 10% and the repeal of the investment credit, tax equity demands that the small corporation be given some additional tax advantages. We recommend that the "normal" corporate tax be applied to the first $100,000 of corporate taxable income in lieu of restructuring the corporate surtax currently in the law.

The fiscal effect of increasing the level of surtax exemption from $25,000 to $100,000 is almost exactly equal to lowering the tax rate 2% on the first 1 million dollars of corporate profits. In the first case the government would lose *approximately $19,500 in taxes (that is, $75,000×26%=$19,500); in the latter case the government would lose $20,000 (2%×$1 million=$20,000).*

From the standpoint of the small business community, we believe it is in the national interest to have an additional $20,000 become available for investment to each corporation making less than $100,000 in profits rather than having it available to the corporation making $1 million. Corporations with incomes in excess of $1 million, from the standpoint of tax equity, should not be given under the Tax Reform Bill a tax position preferable to that which they currently enjoy. Disincentives to investment and expansion should fall most heavily on those corporations best able to absorb them. Incentives to investment and expansion should be given to those corporations most needful of them, and this would be accomplished by increasing the level of surtax exemption from $25,000 to $100,000.

B. Accelerated Depreciation Is Needed by Small Business to Keep Growing and to Keep Competitive

In addition to the possible loss of the investment tax credit and the continuation of the tax surcharge, additional hardships on the small business community would be created by enactment of H.R. 13270 in its present form.

The effect of Sec. 452 of the Tax Reform Bill restricting the use of accelerated depreciation by all corporations would be to severely penalize the logical and legitimate objectives of investor-owners of small business corporations to grow and keep modern through reinvestment of equity capital.

In the case of small business, investments are sporadic and any single purchase of equipment is a large percentage of the total capital invested in the business. The "return of capital" in excess of earnings and profits in essence makes more of the small entrepreneur's capital investment available for reinvestment in his company. This provides a source of self-generated growth capital for small business, which otherwise must seek to obtain the capital from some other source, or do without it.

In the case of large corporations, there is constant long-range investment of new capital and the effect of Sec. 452 of the Bill would be relatively minuscule compared with the effect on the smaller corporation. The averaging of depreciation rates by the large corporation results in long-term depreciation which is not substantially different than straight-line depreciation. However, there will be the transitional effect of adjustment of accelerated depreciation to straight-line depreciation.

Rapid depreciation methods were adopted originally in the interest of the small business man to permit quick recoupment of capital for reinvestment, because accelerated depreciation methods more nearly reflect the actual—that is, the true—rate of depreciation of plant and machinery. To keep growing and to keep competitive, the small business rate of reinvestment should at least reflect, or exceed, the true rate of depreciation of plant and machinery.

Congress and Internal Revenue need to be reminded continuously that no one has ever suggested that more than 100% of the value of an investment should be depreciable. To the extent that rapid depreciation rates are offset against profits and income in early years the "piper" must be paid in later years, unless, in fact profits and income generated by substantially-depreciated assets decline in proportion to the depreciation taken. In the latter case no one can really complain. In the former case the government ultimately collects its pound of flesh in the shape of an increased taxable income base.

Now we have no great argument that large corporations, real estate investment trusts, and certain other business ventures may be able to convert some ordinary income into long-term capital gains by use of accelerated depreciation, and that such income may not as "return of capital" normally find its way into capital reinvestment. However, we feel that the tax equity in such situations is being achieved and is better achieved through recapture provisions (such as those now contained in IRC Sections 1245 and 1250) than by the shot-gun approach of the Tax Reform Bill. The shot-gun approach destroys the valid objectives of accelerated depreciation as a device to permit timely modernization and replacement of capital assets by growing businesses.

II. ORGANIZATIONS COMPETING WITH PRIVATE ENTERPRISE IN THE MARKET PLACE SHOULD BE SUBJECT TO THE SAME TAXES AS PRIVATE ENTERPRISE

A. Enactment of section 121 of H.R. 13270 would help stop discrimination against tax-paying business

The earnings of tax-sheltered businesses are indistinguishable in principle from the earnings of an ordinary tax-paying corporation. The earnings are derived from precisely the same activities, and with precisely the same profit motives.

When government provides tax shelters for the profits of these exempt organizations, the government is fostering and supporting unfair competition against the tax-paying business firm.

It is not fair to permit the tax-exempt organization to run in the same competitive race with private enterprise, yet require private enterprise to drag a ball and chain.

The fact that most private enterprisers have more than held their own in such an uneven race attests to the strength of the private enterprise system. But how many private enterprisers have been forced to give up because of the unfair conditions under which they were forced to compete?

Section 121 of H.R. 13270 is a constructive step because it strengthens private enterprise, the economic foundation of this nation.

B. Taxing profits of co-ops

Meaningful tax reform with respect to cooperatives is presented in S. 2646 (introduced by Senator Ribicoff). It puts the co-op on the same tax basis as other business enterprises, making the co-op fully taxable on the profits which it earns. We endorse the provisions of S. 2646 with respect to cooperatives. We urge their substitution for Sec. 531 of H.R. 13270.

The impact on private enterprise from cooperatives is staggering. The Cooperative League of the USA boasts that:

Co-ops are the source of about 20% of supplies for farmers;

Mutual insurance is growing at about twice the insurance-industry rate;

Credit unions account for about 12%—$9.2 billion—of the installment credit outstanding in the United States;

In addition farmers market about 30% of all their products through cooperatives;

The co-op share *of all marketing* of farm products is—

67% of dairy products
38% of grain, soybeans
29% of fruit, vegetables
25% of cotton and products
14% of livestock and products
9% of poultry and products.

The co-ops account in this country for

31% of all sales of fertilizer and lime
28% of all sales of petroleum products
22% of all sales of seed
19% of all sales of feed
16% of allsales of pesticidies.

Five co-ops are among the 500 largest U.S. corporations.

They are:

Name of Cooperative	Ranking among country's corporations	Annual volume (millions)
Agway Inc., Syracuse, N.Y.	188th	$580
Farmland Industries, Kansas City, Mo	244th	372
Land O'Lakes Creameries, Minneapolis, Minn	251st	367
Cotton Producers Association, Atlanta, Ga	312th	272
Farmers Union Central Exchange, St. Paul, Minn	471st	153

A partial indication of the growth of the co-op movement is reflected in the following compilation prepared by The Cooperative League of the USA.

NUMBERS, MEMBERS, AND BUSINESS VOLUME OF COOPERATIVE AND MUTUAL ORGANIZATIONS

[Figures are for latest available year]

Kind of co-op	Purpose	Number of co-ops	Individual members	Dollar volume (thousands)	Remarks and significant trends
Consumer goods centers	Food and home supplies	[1] 826	572,501	753,844	Smaller co-op stores will be found throughout the Nation, but especially in the Great Lakes area of Minnesota and Wisconsin.
Credit unions	Thrift and credit	23,207	19,070,000	[2] 11,100,000 [3] 9,900,000	Credit unions are expanding to provide full financial services, including travelers checks, money orders, even government securities. Number of credit unions increased by 515 in 1967.
Electric co-ops	Rural electricity	924	5,000,000	896,930	About 91 percent of the co-ops' meters are on farms and in churches, schools, and business and industries. Rural electric co-ops are leading the battle to achieve rural-urban balance.
Farm credit system:					
Banks for co-ops	Credit for co-ops	13	[4] 3,000	1,700,000	Volume figures represent loans made during fiscal year 1968, an increase of 11.3 percent over fiscal 1967. At the close of the fiscal year the system's net worth was $2,000,000,000, only 6.5 percent of which was government capital.
Federal land bank associations	Long-term farm credit	686	400,000	1,300,000	
Production credit associations	Production credit	459	546,000	5,400,000	
Farm marketing	Higher returns for producers	5,100	3,760,000	12,850,000	About ¾ of all farmers are members, marketing through co-ops 25 to 30 percent of all they produce at some stage. Figures projected for 1967.
Farm purchasing	Production and home supply savings	2,900	3,060,000	3,225,000	Farmers purchase 20 percent of all farm production supplies from co-ops. Nonfarm persons also join to purchase home, garden supplies. Figures projected for 1967.
Farm service	Trucking, storage, ginning, grinding, other services.	180	35,000	330,000	In addition to co-ops primarily performing services, 68 percent of farm marketing and 53 percent of supply co-ops perform one or more services. Figures projected for 1967.
Group health plans	Prepaid health care	180	7,000,000	[illegible]0,000	These include community, consumer, union, and employee-employer sponsored plans. "Members" refers to individuals.
Housing	Homes	680	173,000	250,000	The $250,000,000 contains some payments for playgrounds, pools, and other community facilities. "Members" refers to family units.
Insurance, co-op oriented	Financial security	15	11,850,000	776,200	In addition, there are hundreds of farmers' mutuals, workmen's benefit societies, and other groups serving additional millions of members. Dollar volume is annual premium income.
Memorial societies	Dignified last rites	101	300,000	1,300	Dollar volume represents estimated savings to families. Some co-ops operate their own funeral facilities, but most contract with funeral directors or simply represent their members' wishes.
Nursery schools	Preschool child care	1,440	72,000	6,840	Parents usually do part of the work in these cooperatives, thus sharing in child-raising experiences as well as saving money.
Student co-ops	Room and board, books, social activities.	400	400,000	29,660	These estimates include cooperative bookstores, as well as the houses in which students get room or board or both.
Telephone co-ops	Rural telephone service	232	632,000	65,000	With 80 percent of America's farms now enjoying telephone service, phone co-ops emphasize upgrading service—reducing the number of party lines and parties on a line, providing dial service.

[1] Stores.
[2] Savings.
[3] Loans outstanding.
[4] Co-ops.

Source: Co-op report, September 1968.

The "big business" diversification aspect of the co-op is reflected in this report on one of the regional farm supply co-ops:

"Midland Cooperatives' membership now numbers 300,000 families through 700 affiliated co-ops. *Petroleum continued to be a major line*, with refineries producing at almost 100% capacity. *Fifty-one new wells were drilled.* Fertilizer, seed and chemical sales showed a 20% jump. *Midland's 170-unit trucking fleet is one of the nation's largest private carriers.*" (Source: Co-op Report, Sept. 1968. Emphasis supplied.)

The shelter now provided special privilege organizations, such as the co-op, is leading to the destruction of the economic tax base of this country. The exemption is a cancer feeding on tax-paying business and on the federal revenue. The Wall Street Journal in discussing farm co-ops gave this correct analysis:

"Thus the Government has created a kind of Gresham's tax law; the people who don't pay taxes drive out of business the people who do.

"Aside from the economic unfairness of saddling one group of people with high taxes and granting another group of people the right to do the same business with no like taxes to pay, there is a question about the economic soundness of any such government policy.

"Actually it comes down to this question: If all the taxpayers were driven out of business by non-taxpayers, who'd pay the taxes?" (Source: Editorial, Wall Street Journal, 4-10-58.)

We favor the placing of co-ops on the same tax basis as other business enterprises, making them fully taxable on the income which they earn. Where those earnings are subsequently distributed to owner-patrons, the owners should be taxed the same as corporate dividends are now. Senator Ribicoff has proposed this in S. 2646, and we recommend your favorable consideration of his approach to the co-op problem.

In letters to the Washington Post published on Sept. 21, 1969, spokesmen for The Cooperative League of the USA and the National Council of Farmer Cooperatives criticized Sec. 531 of H.R. 13270 as "a punitive measure (which) takes away the right of co-op members to leave some of their funds in their co-op for growth needs and to provide development capital."

The Washington Post is to be commended for putting the taxation of co-ops in proper focus. In an Editor's Note, it correctly said:

"Co-operative corporations, under present law, avoid all tax liability by paying 20 per cent of their patronage dividends to members in cash. This gives the co-ops a competitive advantage because 80 per cent of earnings can be retained for reinvestment. But the member is liable on his personal income tax report for 100 per cent of his share of the earnings. The House, therefore, proposed that the co-ops be required to pay out an additional 30 per cent in cash (phased out over a 10-year period). This would make it more likely that the patron would have enough cash to cover the tax liability on his total earnings, and at the same time would reduce the co-ops' retained earnings advantage. *But what is actually needed beyond this first step toward equity is something like the Ribicoff bill, which would levy a tax on co-ops themselves, plugging a $200 million loophole.*" (Source: WASHINGTON POST, 9-21-69. Emphasis supplied.)

We believe the Washington Post has understated considerably the size of the loophole.

The public has the right to know how many tax dollars are being avoided by co-ops and other exempt organizations in direct competition with tax-paying businesses.

The facts—not guesstimates—are available to your Committee from the Treasury Department, the Internal Revenue Service, the Farmers Cooperative Service of the Department of Agriculture, the Bureau of Federal Credit Unions, and other governmental agencies.

C. How Can Congress Justify a Policy That Perpetuates Unfair Competition and Promotes Monopoly?

Regardless of the size of the loophole, there is a more important reason for plugging the loopholes now being exploited by exempt organizations, and that reason is: how can Congress justify on a factual basis a policy that is perpetuating unfair competition and promoting monopoly?

Our Association consists of 35,000 small business units.

They are taxpayers in more than 500 categories of business—manufacturing, wholesaling, retailing, professional, and service.

Exempt organizations are competing with these taxpaying business units for the same consumer's dollar. They perform the same commercial function as the taxpaying business unit. But because of their tax loophole, they pay relatively no taxes. Thus they can afford to cut prices to gain a greater stranglehold on the market; or they can use their profits for expansion; or they can use their profits to acquire competitors (primarily small business units). The end result is the same: less competition and a trend toward monopoly.

The immediate damage to small business, and to the public welfare, is obvious. The long-range damage to the private enterprise system, the economic foundation of this country, can be disastrous.

III. OUR PROPOSALS PROMOTE FISCAL SOUNDNESS

Although precise figures are unavailable to us, it is our belief that plugging only those loopholes mentioned in this statement would more than offset raising the surtax exemption from $25,000 to $100,000.

Fiscal soundness is essential to our nation and we propose nothing to weaken it.

On the contrary, we believe our proposals will strengthen fiscal soundness by encouraging a sound long-range build-up of a vital productive sector of our economy.

Thank you for the opportunity to present our views.

The CHAIRMAN. Thank you very much, sir.

Senator CURTIS. Mr. Chairman, one question.

Do I understand that what you are proposing is that the deduction be put on the normal corporate tax and not the surtax?

Mr. BECK. No, sir. We are proposing that the point at which the surtax applies first be raised from $25,000 to $100,000, and that only the normal 22-percent tax apply up to $100,000, and the 26-percent surtax begin to take over from $100,000 up.

Senator CURTIS And no change in the rates?

Mr. BECK. No, sir; we are recommending no change in the rates at this time. Like everyone, we are for tax reduction, but we do not feel that this is the time that tax reduction should be encouraged.

Senator CURTIS. That is all.

The CHAIRMAN. Thank you very much.

Senator MILLER. Mr. Chairman, I just want to make a comment. I think the suggestion is a very constructive suggestion. I like the idea that you have of a tradeoff which nets the same revenue to the Treasury, and I think that is something that we ought to consider very carefully.

Mr. BECK. May I just add to that please Senator Miller. You are correct that the proposal to increase the surtax exemption to $100,000 would be almost an exact tradeoff for lost revenue from the Treasury proposal to decrease corporate tax rates 2 percent. However, in addition, our proposal to close tax loopholes now afforded to tax-exempt cooperatives, would generate, we believe, sufficient additional revenue to offset the estimated $1.49 billion revenue loss entailed in either our own proposal or the Treasury proposal. We have no way of estimating the amount of revenue from tax-exempt cooperatives, but we well think it would be at least equal to if not greater than $1.49 billion.

Senator MILLER. I understood that your reply to Senator Curtis indicated that it did amount to a tradeoff, by increasing the point for the surtax exemptions to apply from $25,000 to $100,000, we are going to lose some revenue, but on the other hand by not lowering the overall rate by one point and then two points as Treasury has recommended, we are going to gain some revenue, and so that the net amount to the Treasury is going to be the same.

Mr. BECK. Except, sir, that in addition closing the tax loopholes for the cooperatives and the tax-exempts will, we think, provide an additional amount of extra revenue of perhaps $1.5 billion, but we have no figures available as your committee undoubtedly does, as to what these figures might be. So we are saying that there is more gain than just a tradeoff.

Mr. KILCULLEN. May I have just one moment to make a point. As Mr. Beck said I represent the Conference of American Small Business Organizations which is somewhat of a sister organization to the National Small Business Association. We would like to express this particular point, and I have a statement which I would like to offer. It is a very short statement.

If genuine tax reform is to be accomplished by the present Congress recognition must be given to the need for tax relief for small business. This important segment of our national economy has been all but ignored throughout the lengthy deliberations on H.R. 13270 in the House of Representatives, and the Senate now has the opportunity and the duty to correct this grave oversight.

The accelerating trend in recent years toward concentration of business activities in large corporate entities has resulted in a steady erosion of the small business community. Among the factors responsible for this are the excessive burden of taxes imposed by Federal, State, and local governments, and the diminishing amount of reinvestment capital available to the small businessman to keep his business going.

The tax burden of the American small businessman is disproportionately greater than that of his counterparts in other countries. In addition to the massive Federal income tax which takes away roughly 50 percent of every profit dollar, he must also pay State income taxes, State and local taxes on equipment and property, business franchise taxes, payroll taxes, including social security and unemployment compensation taxes, various excise taxes and use taxes, and any other form of tax that the fertile minds of the taxing authorities can invent.

While large corporations can pass the tax burden along to the consumer in the price of goods and products produced it is frequently impractical or economically unfeasible for small business firms to increase the price of their goods and services, and all too often the small firm ends up absorbing additional taxes through a reduction of its level of return.

For sound business reasons most small business firms must adopt a corporate form although this necessarily carries with it somewhat heavier tax consequences than would an individual proprietorship or partnership. Without a corporate form it would be impossible in most instances to obtain equity financing, or other forms of capital required. All businesses today must continually modernize their plant and equipment and improve their business technology in order to remain competitive. The need for investment capital for such purposes is a continuing and vital problem for the small businessman, but his sources of capital are much more limited than those of the large corporations. Because of this the costs of modernizing and improving his business technology must come largely from reinvestment of the profits from the business.

H.R. 13270 not only fails to take into account the small businessman's continuing need for reinvestment capital but would accentuate his present problems by eliminating the relatively small advantage of the 7-percent investment credit. In our view this is the exact reverse of the direction the Congress should be taking to accomplish sound and equitable tax reform.

The most direct and uncomplicated method of providing equitable tax relief to small business would be to raise the corporate surtax exemption base from its present level of $25,000 to a substantially higher level. This level should, we feel, be $100,000 if it is to provide any substantial tax relief to that segment of small business which needs it most. At present a firm with net taxable income of $100,000 pays a whooping $45,650 in Federal income tax (including the 10 percent surcharge), and several thousand dollars more in State income taxes. This is such an unfair tax burden that its effect is to discourage initiative and effort by the small entrepreneur. After he has taken all the risks, invested his time and skill, and done all the work, his noncontributing partner, the Government, comes along and takes half of all the earnings. Such a grossly unfair arrangement would have shocked the conscience of previous generations of Americans, but we now accept and tolerate it as a built-in condition of business life.

By any fair measure the Government's share of the small businessman's earnings should not exceed 25 percent of the first $100,000. A business with earnings above that level can, for the most part, support a higher percentage of tax, although we cannot agree that the present 48 percent rate is fair and reasonable. Our immediate concern, however, is that some relief be given in the lower brackets of small business earnings, and we urge this committee and the Senate to accomplish this by raising the present corporate surtax exemption.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

The next witness is Mr. Robert G. Skinner, executive committee, division of federal taxation, American Institute of Certified Public Accountants.

Mr. Skinner, you have a statement here that is over 100 pages in length which I do think we ought to carefully study. I regret that you are limited to 10 minutes to summarize the statement because I know that you are in a position to give us some very fine advice.

Our staff has carefully studied what you have prepared for us, and it will be considered, but unfortunately I think you understand our predicament. We are committed, at least I am, to try to report a bill by October 31, and under the pressure of the circumstances we will have to hear you briefly.

STATEMENT OF ROBERT G. SKINNER, EXECUTIVE COMMITTEE DIVISION OF FEDERAL TAXATION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY HERBERT FINKSTON

Mr. SKINNER. Thank you. We will keep our remarks to 10 minutes.

The CHAIRMAN. As a matter of fact, our staff has summarized your statement and the summary runs four pages itself.

Mr. SKINNER. I am a member of the executive committee of the American Institute of Certified Public Accountants. I am accompanied by Mr. Herbert Finkston, who is a member of the institute's tax staff.

We are appearing today, of course, on behalf of the institute.

As you may know, the AICPA is the sole national organization of professional certified public accountants. It was established in 1887, and it currently has approximately 70,000 members.

As the others have stated, we also appreciate this opportunity to express our views on the vital issue of tax reform. We have prepared for consideration by your committee a detailed analysis and a summary of our comments on selection provisions of the tax reform bill.

In addition, we firmly believe that any continuing effort in pursuit of tax reform at this time should also include consideration of substantive technical amendments of the Internal Revenue Code which perpetuate inequities, which give unintended benefits and which create unintended hardships.

The tax division of the institute has prepared a booklet entitled "Recommendations for Amendments to the Internal Revenue Code," which lists and explains a number of substantive technical proposals which we believe should be enacted into law.

We would appreciate it if both our summary and our detailed presentation together with our booklet and these oral comments are included in the record of these hearings.

While there was some disagreement within our tax division on the merits of the various provisions of the House bill, there was one conclusion on which agreement was unanimous—the incredible complexity of the legislation.

Provisions such as those dealing with private foundations, farm losses, the foreign tax credit and the limit on tax preferences will prove to be very difficult to apply and to administer. In many cases proposed changes contained in the bill do not replace current sections of the law. Instead, the new proposals would further complicate an already too complex self-assessment tax system.

One of the services performed by our institute members in their accounting practices is tax return preparation. CPA's probably prepare the bulk of tax returns filed in the United States which are not considered simple. We are very seriously concerned that the overall effect of this reform bill as it now stands will be overwhelming, and it may even lead to some noncompliance.

We urge your committee to carefully weigh the reform objectives sought here in light of the burden that the House proposals would impose on this Nation's taxpayers, as they seek to interpret and comply with them.

In the remaining time available for us today, we would like to emphasize three additional measures that we feel should be included in any tax legislation approved by your committee this year.

There has been a significant and widespread increase in the efforts of revenue agents to tax advance payments and deposits for both goods and services, without regard to the matching of related costs and without regard to whether these advances are refundable. Adjustments of this nature proposed by revenue agents have been stimulated by a series of recent court cases, in which the Commissioner has been sustained in taxing advance payments from the sale of goods rather than just the income from these sales.

In effect, these cases hold that upon receipt of the sales price, or any part of it, the amounts so received must be included in taxable income. Only when the merchandise is subsequently shipped or delivered, or when title passes to the customer, is a deduction allowed for the related costs.

The fact that these two events take place in different years, distorting the income of both years, has been disregarded. One circuit court has held that inclusion in gross income of the entire amount of advance payments, without an allowance for related cost of goods sold, would constitute taxation of the return of capital. Nevertheless, the circuit court affirmed the decision of the Tax Court because the taxpayer did not establish an amount for the cost of goods sold applicable to the advance payments.

The treatment that the courts have approved in this area violates the annual accounting concept which requires the matching of revenue with related costs and expenses. The courts have, in effect, completely disregarded this principle.

The seriousness of this problem should not be underestimated. It is altogether possible that unless relief is granted in this connection, some manufacturers could be taxed out of existence.

Several years ago Congress assisted in the resolution of a similar problem. Automobile clubs had been accounting for dues revenue ratably over the period to which the dues applied. The Commissioner proposed that dues revenues should be recognized in the year received and that the related expenses should not be deductible until later years when they were actually incurred.

The courts supported the Commissioner's treatment which was completely contrary to the accounting principle of matching revenue with related costs and expenses. As a result, section 456 was eventually enacted to remedy the problem. Section 455 provides similar treatment for prepaid subscription income.

Our tax division urges Congress to take similar action regarding the taxation of advance payments for merchandise. We propose that section 451 of the code be amended by adding a new subsection which would simply provide that payments received for goods sold by a taxpayer in the ordinary course of his trade or business should be included in income in the year in which the sale takes place.

For this purpose the method of accounting regularly employed by the taxpayer in keeping his books should be determinative.

Alternatively, section 451 could be amended to make it clear that gross income from the sale of merchandise or other property is the gain from such a sale and not the gross receipts from the transaction.

Section 367 of the code provides that certain provisions of subchapter (c) (covering liquidations of controlled subsidiaries, transfers to controlled corporations and specified reorganization exchanges and distributions) will not be applicable to foreign corporations unless, prior to the transaction, the Secretary of the Treasury or his delegate determines that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

The Secretary of the Treasury or his delegate should be given statutory authority to make a determination after an exchange that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Notwithstanding the similarity of purpose and structure of code section 367 and sections 1491 and 1492, section 1494(b) provides that the tax otherwise imposed by section 1491 may be abated, remitted or refunded if, after the transfer, it is established to the satisfaction of the Secretary or his delegate that the proscribed tax avoidance purpose did not exist. Legislative history discloses no reason for withholding similar relief from the impact of section 367 which, because it requires a ruling in advance of the exchange has been and continues to be a trap for the unwary.

Moreover, recent experience has indicated that rulings under section 367 have been delayed for 6 months and longer, even where the Internal Revenue Service has agreed to expedite the case, resulting in expensive hardships for taxpayers.

The cost of purchased goodwill, trademarks, trade names and other similar intangible assets should be amortizable over a stated period fixed by statute to the extent that these costs are not otherwise deductible under other sections of the code.

Under present law a taxpayer can amortize costs of this nature only if a definitely determinable useful life can be established, or failing that, upon proof of the abandonment of the asset. Many court decisions and Internal Revenue Service rulings have held that no amortization is allowable where these tests are not met, even though the value of the intangible asset obviously has been impaired.

We recommend an amendment of the code provide that if a definite life cannot be determined for a purchased intangible asset, its cost can be amortized over a period of 10 years or, at the election of the taxpayer, over a longer period.

Section 1245 should provide, if it does not now do so, for recapture of amortization when the intangible asset is sold or otherwise disposed of in a transaction covered by that section.

We have presented our recommendations, both oral and written, with the hope that they will prove helpful. If it should appear that our tax division could assist you or your staff in your analysis of the various proposals, we would be pleased to do so in any way that you might wish.

Thank you for giving us this opportunity to present our comments to you.

The CHAIRMAN. Thank you very much. We have quite a bit of testimony concerning what you are saying.

I am impressed that you represent the group that ought to be able to understand all of the complexities of the tax law as well as anybody because you work with it every day. I made the statement in opening these hearings that what the House has sent us is 368 pages of bewildering complexity. Is that what you find?

Mr. SKINNER. I would agree with that. We say without any regard to selfinterest, although we probably can understand it almost as well as anyone can, that we think it is wrong for a self-assessment system to require so much professional assistance by the people who are assessing themelves.

The CHAIRMAN. The old people came in here trying to explain their retirement income and they said no two accountants or two lawyers could figure out what some poor old man owes and arrive at the same conclusion. You are aware of that statement?

Mr. SKINNER. I am not aware of it specifically but I can understand and sympathize with it.

The CHAIRMAN. That reminds me of the compromise we finally worked out when we were trying to tax foreign income some years ago. By the time we got through with it some of the best lawyers in America told me you could take any team of lawyers and accountants and put them to work on any corporation's tax problems, and no two sets of lawyers and accountants who could arrive at the same dollars and cents figure. They said there is no way on earth you could read that language and have two inteligent men working independently arrive at the same conclusion.

Mr. SKINNER. I think that is a perfect example of the results that you achieve with the complexities that we have. I agree with that.

Senator CURTIS. I have a question or two.

I noticed by the summary you support clarification of the provision relating to farm losses?

Mr. SKINNER. Yes, sir.

Senator CURTIS. Are you willing to apply it to all businesses?

Mr. SKINNER. Certainly we would.

Senator CURTIS. To all businesses. In other words, you will apply the rule to all businesses that over a period of years and have continued losses, that those losses be disallowed?

Mr. SKINNER. No. Perhaps I misunderstood the question. I thought you said clarification and simplification of the areas. The thrust of our comments in the farm loss area was with reference to complication and clarification.

Senator CURTIS. I think it is without question that the farmers are treated in the way that no other business is by the House bill.

I would like to also ask you this question. I know of a college fraternity that its national office has an endowment fund that every member makes a contribution to when he belongs to the fraternity. This money is used predominantly to make loans, to build chapter houses, chapters located on the college or university campuses.

These local chapters pay interest for the use of this money. We are in a situation where the Federal Government is spending money and making loans for college housing, that here we have a fraternal organization, but do I understand your statement that you would tax that fraternal organization even though no profit accrues to anybody?

Mr. SKINNER. I do not know that our statement covers that. Is this in the exempt organizations area?

Senator CURTIS. I find right here it says "taxation of investment income of social, fraternal and similar organizations" that you support it.

Mr. SKINNER. We would support generally the unrelated business income proposals to the extent——

Senator CURTIS. No, this is an investment income. Now maybe the summary is wrong, I do not know. It is found on page 10.

Mr. SKINNER. On page 44 of our prepared testimony we state this: that "(t)he bill provides for the taxation (at regular corporate rates) of investment income and other unrelated income of social clubs, fraternal beneficiary associations, and voluntary employees' beneficiary associations. This will not apply, however, to such income of fraternal beneficiary associations and voluntary employees' beneficiary associations to the extent it is set aside to be, used only for the exempt insurance function of these organizations and for charitable purposes. If in any year an amount is taken out of the set-aside and used for any other purpose, the amount taken out will be subject to tax in such year."

Our executive group is made up of nine people. We require a two-thirds vote to act. Our executive group agreed to support the House proposals in this area without specific comment.

Senator CURTIS. What you have submitted here is arrived at by nine people?

Mr. SKINNER. Yes. These are the members of our executive group. However, they have the authority under the organization of our institute to evaluate comments.

I might add that the comments were studied in detail by subcommittees and special groups of tax specialists who spend their full time in working with tax measures.

Senator CURTIS. I will ask you personally. Do you favor the taxation this college fraternity as I mentioned where their sole investment is helping their chapters acquire housing for students to live in, and in turn they pay interest on it? Now, would you tax that?

Mr. SKINNER. Personally, I would see no reason why that should not be taxed, provided it was offset by all related expenses. I am speaking now of a fraternity as separate and apart from the educational institution itself.

Senator CURTIS. That is all.

Senator MILLER. I would like to ask a question on these comments of yours relating to corporate mergers and the interest deduction matter. I am inclined to agree with your observations. But as I understand it, on some of these transactions the investor receives not only a debenture but he receives a warrant. Now, he is content to receive the debenture paying a lower rate of interest than some other kind of debenture which is not convertible, because that warrant could be sold and of course if he held it long enough he gets capital gains, so it offers a gimmick whereby he can in effect convert interest income into capital gain.

In a situation like that, whether it is with respect to a merger or any other type of financing, it is an across-the-board approach, would you support a provision which would require that any profit made from the sale of such warrant shall be treated as ordinary income?

Mr. SKINNER. Senator Miller, I observed your comments earlier here, and I might add that I think that a big part of the solution to problems in this area would be a much clearer definition of the differences between equity capital and borrowed capital or debt.

Senator MILLER. This would be one way to tackle that?

Mr. SKINNER. That is right. I agree with that, and I agree with you, or I think I agree with you, that an approach to the objections to conglomerate mergers, wheeling and dealing, and mergers and acquisitions in our society today ought to be tried somewhere other than through the tax laws before we resort to this.

Senator MILLER. Yes; but do you agree with me that in the example I gave you, that the sale of that warrant could well be taxed as ordinary income?

Mr. SKINNER. Yes; I think that this would be appropriate under those circumstances.

Senator MILLER. Whether it is involved in a merger or something else?

Mr. SKINNER. Yes.

Senator MILLER. It does not make any difference?

Mr. SKINNER. It gets again down to the essence of what the nature of the asset is. Is it equity or is it debt?

Senator MILLER. Thank you.

The CHAIRMAN. Thank you.

(Robert G. Skinner's prepared statement with attachment follows. Oral testimony of the next witness commences at page 4846.)

STATEMENT OF ROBERT G. SKINNER

My name is Robert G. Skinner. I am a member of the Executive Committee of the Division of Federal Taxation of the American Institute of Certified Public Accountants. I am accompanied by Herbert Finkston, a member of the Institute's tax staff. We are appearing here today on behalf of the Institute.

The AICPA is the sole national organization of professional CPAs. It was established in 1887 and currently has approximately 70,000 members.

We appreciate the opportunity to express our views on the vital issue of tax reform. We have prepared for consideration by your Committee a detailed analysis and a summary of our comments on selected provisions of H.R. 13270. In addition, it is our firm belief that any continuing effort in pursuit of tax reform at this time should also include consideration of substantive technical amendments of existing provisions of the Internal Revenue Code which perpetuate inequities, give unintended benefits and create unintended hardships. The Tax division of the Institute has prepared a booklet entitled "Recommendations for Amendments to the Internal Revenue Code" which lists and explains a number of substantive technical proposals which we believe should be enacted into law.

We would appreciate it if both our summary and detailed presentation together with our booklet and these oral comments are included in the record of these hearings.

While there was some disagreement within our Tax Division on the merits of various provisions of the House Bill, there was one conclusion on which agreement was unanimous—the incredible complexity of the legislation. Provisions such as those dealing with private foundations, farm losses, the foreign tax credit and the limit on tax preferences will prove to be very difficult in application and administration. In many cases proposed changes contained in the Bill do not replace current sections of the law; instead, the new tax reform proposals would further complicate an already too complex self-assessment tax system.

One of the services performed by Institute members in their accounting practices is tax return preparation. CPAs probably prepare the bulk of tax returns filed in the United States which are not considered simple. We are seriously concerned that the overall effect of this reform Bill will be overwhelming and may even lead to noncompliance. We urge your Committee to carefully weigh the reform objectives sought here in light of the burden that the House proposals would impose upon this nation's taxpayers as they seek to interpret and comply with them.

In the remaining time available today, we would like to emphasize three additional measures that we feel should be included in any tax legislation approved by your Committee this year.

TAXATION OF PAYMENTS FOR MERCHANDISE OR OTHER PROPERTY RECEIVED PRIOR TO THE OCCURRENCE OF SALE

There has been a significant and widespread increase in the efforts of Revenue Agents to tax advance payments and deposits for both goods and services without regard to the matching of related costs and without regard to whether these advances are refundable. Adjustments of this nature proposed by Revenue Agents have been stimulated by a series of recent court cases in which the Commissioner has been sustained in taxing advance payments from the sale of goods rather than just the income from these sales.

In effect, these cases hold that upon receipt of the sales price, or any part of it, the amounts so received must be included in taxable income. Only when the merchandise is subsequently shipped or delivered, or title passes to the customer, is a deduction allowed for the related costs. The fact that these two events take place in different years, distorting the income of both years, has been disregarded. One Circuit Court has held that inclusion in gross income of the entire amount of advance payments, without an allowance for related cost of goods sold, would constitute taxation of the return of capital. Nevertheless, the Circuit Court affirmed he decision of the Tax Court because the taxpayer did not establish an amount for the cost of goods sold applicable to the advance payments. The treatment that the courts have approved in this area violates the annual accounting concept which requires the matching of revenue with related costs and expenses. The courts have, in effect, completely disregarded this principle. The seriousness of this problem should not be underestimated. It is entirely possible that unless relief is granted in this connection, some manufacturers could be taxed out of existence.

Several years ago Congress assisted in the resolution of a similar problem. Automobile clubs had been accounting for dues revenue ratably over the period to which the dues applied. The Commissioner proposed that dues revenue should be recognized in the year received and that the related expenses should not be deductible until later years when they were actually incurred. The courts supported the Commissioner's treatment which was completely contrary to the accounting principle of matching revenue with related costs and expenses. As a result, section 456 was eventually enacted to remedy the problem. Code section 455 provides similar treatment for prepaid subscription income. Our Tax Division urges Congress to take similar action regarding the taxation of advance payments for merchandise.

We propose that section 451 of the Code be amended by adding a new subsection which would simply provide that payments received for goods sold by a taxpayer in the ordinary course of trade or business shall be included in income in the year in which the sale takes place. For this purpose the method of accounting regularly employed by the taxpayer in keeping his books shall be determinative.

Alternatively, section 451 could be amended to make it clear that gross income from the sale of merchandise of other property is the *gain* from such a sale and not the *gross* receipts from the transaction.

RELAXATION OF REQUIREMENTS FOR ADVANCE RULINGS REGARDING TRANSACTIONS INVOLVING FOREIGN CORPORATIONS

Section 367 of the Code provides that certain provisions of Subchapter C (covering liquidations of controlled subsidiaries, transfers to controlled corporations, and specified reorganization exchanges and distributions) will not be applicable to foreign corporations unless prior to the transaction the Secretary of the Treasury or his delegate determines that the transaction "is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

The Secretary of the Treasury or his delegate should be given statutory authority to make a determination *after* an exchange that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Notwithstanding the similarity of purpose and structure of Code section 367 and sections 1491 and 1492, section 1494(b) provides that the tax otherwise imposed by section 1491 may be abated, remitted or refunded if, after the transfer, it is established to the satisfaction of the Secretary or his delegate that the proscribed tax avoidance purpose did not exist. Legislative history discloses no reason for withholding similar relief from the impact of section 367 which, because it requires a ruling in advance of the exchange, has been and continues to be a trap for the unwary.

Moreover, recent experience has indicated that rulings under section 367 have been delayed for six months and longer—even where the Internal Revenue Service has agreed to expedite the case—resulting in expensive hardships for taxpayers.

AMORTIZATION OF INTANGIBLE ASSETS

The cost of purchased goodwill, trademarks, trade names, secret processes, formulas, licenses and other similar intangible assets should be amortizable over a stated period fixed by statute to the extent that these costs are not otherwise deductible under other sections of the Code.

Under present law, a taxpayer can amortize costs of this nature only if a definitely determinable useful life can be established or, failing that, upon proof of the abandonment of the asset. Many court decisions and Internal Revenue Service rulings have held that no amortization is allowable where these tests are not met—even though the value of the intangible asset obviously has been impaired.

We recommend an amendment of the Code to provide that if a definite life cannot be determined for a purchased intangible asset, its cost can be amortized over a perid of 120 months or, at the election of the taxpayer, over a longer period.

Section 1245 should provide, if it does not now do so, for recapture of amortization when the intangible asset is sold or otherwise disposed of in a transaction covered by that section.

We have presented our recommendations with the hope that they will prove helpful. If it should appear that our Tax Division could assist you or your staff in your analysis of the various proposals, we would be pleased to do so in any way that you wish. We appreciate this opportunity to present our comments to you.

SUMMARY OF COMMENTS ON H.R. 13270, THE TAX REFORM ACT OF 1969

This summarizes our views on selected provisions of H.R. 13270. The Division of Federal Taxation supports many of the provisions of the Bill. This summary will be confined to those provisions where difficulties are perceived.

PRIVATE FOUNDATIONS

While we agree with the intention of the Bill to curb abuses by private foundations, we are unable to express a consensus of opinion on the provisions of the Bill regarding private foundations. However, we do support the prohibitions on self-dealing.

The Bill in this area is comprehensive and extremely complex. So much so that it is difficult to determine whether the abuses sought to be corrected will be accomplished without unnecessarily restricting the appropriate activities of private foundations. Equally difficult to determine without extensive analysis are the socio-economic consequences which may result from the enactment of the present provisions of this Bill.

Notwithstanding our inability to express a consensus of opinion on the private foundation provisions of the Bill, we hope that the following suggested modification will assist your Committee to properly evaluate the House proposals in this area.

1. The tax on investment income should be limited to the extent it is intended to raise revenue. It should not be imposed as a "user" fee.

2. While it is difficult to object to the imposition of the proposed tax on termination of exempt status for willful repeated acts or for a willful and flagrant act (proposed Code section 507), the computation of the aggregate past tax benefits is too complicated and seems unnecessary in view of the circumstances under which the tax would be imposed.

3. The tax on failure to distribute (proposed Code section 4942) requires that allowance for amounts set aside for future projects be established to the satisfaction of the Internal Revenue Service at the time they are set aside. In view of the penalties for failure to distribute, the Service will be able to prevent the setting aside of amounts merely by failing to act on applications or through the manner in which information supporting the amounts set aside

is required to be filed. Foundations should be permitted to support these "set-asides" later.

4. The Bill limits to 20 percent the combined ownership of the corporation's voting stock which may be held by the foundation and all disqualified persons. We believe that this percentage limitation should be 35 percent.

5. The tax on investments which jeopardize charitable purposes (proposed Code section 4944) is too punitive considering the subjective nature of the act that would give rise to the tax. Any investments that experience a loss in value would be regarded by some as having jeopardized the exempt purposes. As a minimum, there should be a "correction period" as provided in proposed Code section 4941(e)(4).

6. The attribution rules included in proposed Code section 4946(a)(3) for determining "disqualified persons" should be modified to follow the rules of section 318(a) rather than Code section 267(c), or section 267(c)(3) should be modified to apply only to partners having an interest of 10 percent or more.

OTHER EXEMPT ORGANIZATIONS

1. Clay B. Brown Case

Section 121(d) of the Bill is intended to deal with the *Clay B. Brown* problem. However, it seems unnecessarily harsh in attempting to tax all debt-financed income. As an alternative, the present exemption from the unrelated business income tax for rents from personal property leased with realty could be eliminated. This would prevent *Clay Brown*-type transactions by taxing the rent from any lease for whatever term where personal property constitutes more than an incidental or insubstantial portion of the property subject to the lease.

2. Extension of Unrelated Business Income Tax

The Bill would extend the tax on unrelated business income to additional exempt organizations, including churches, social welfare organizations, social clubs and fraternal beneficiary societies. To the extent these organizations operate business enterprises that are unrelated to their exempt purposes, they are permitted to compete unfairly with taxable entities. We support the extension of the tax in these circumstances; however, we recommend that the specific deduction allowed in the determination of unrelated business income be raised from $1,000 to $5,000. This should eliminate much of the burden of compliance by the organizations and audit by the Internal Revenue Service.

In the case of social clubs, the Bill proposes that income from nonmember activities should be taxed. Allocation of income and expenses between member and nonmember activities will present difficult accounting and definitional problems that should be provided for more clearly.

3. Advertising Income Derived From Periodicals of Exempt Organizations

Section 121(c) of the Bill proposes to make clear that the regulations promulgated in December 1967 by the Treasury Department are in accordance with the intent of the present Congress. We believe that these regulations, in which the advertising activities of a periodical published by an exempt organization are singled out for treatment as an unrelated business, are unrealistic in concept. Further, we believe that it is possible for both the advertising and editorial content of certain of these periodicals to be functionally related to the exempt purposes of the organization. Accordingly, we believe that section 512 or 513 should be amended to incorporate the following concepts:

a. A trade or business should be defined along vertically integrated lines so that advertising activity, alone, cannot constitute a trade or business.

b. If the activities of such defined trade or business are functionally related to the purposes for which an organization has been granted exemption, this trade or business should not be characterized as unrelated to the exempt purposes of the organization.

This approach should prevent the unfair competition that was in the original target of Congress in enacting the tax on unrelated business income.

CHARITABLE CONTRIBUTIONS

With respect to sections 201(c) and (d) of the Bill regarding charitable contributions of appreciated property, we do not favor the distinction drawn between gifts to public and gifts to private foundations. It is our view that contributions of such property should be treated in the same manner without regard to the type of charitable recipient.

FARM LOSSES

We agree with the intended purpose of the proposed legislation to curb abuses of capital gain provisions coupled with the use of losses from farming operations. On the other hand, we believe that the language of section 211 of the Bill is so sweeping that it will affect more taxpayers than intended.

To illustrate, section 211 applies to all taxpayers who, with respect to any taxable year, (1) incur a farm net loss, *or* (2) have a balance in the excess deductions account at the close of the taxable year. An addition to the excess deductions account for a current year's farm loss is not required if (1) nonfarm adjusted gross income is $50,000 or less, and (2) the farm net loss is $25,000 or less. However, it appears that the $50,000/$25,000 de minimis exceptions do not apply to excuse application of section 211 in the face of a current year's loss, no matter how small (proposed Code section 1251(a)(1). Should this be the case, section 211 would apply to all taxpayers incurring a current farm loss, with the result that a great many farmers would be faced with loss of capital gain benefits if they did not elect to adopt certain accounting methods.

To remedy this apparent defect, we recommend that the Bill be clarified so that there is no doubt that the $50,000/$25,000 de minimis exceptions apply also in the case of farm net losses for the current taxable year.

HOBBY LOSSES

We agree with the intended purpose of the proposal for dealing with so-called hobby losses. In our judgment, however, the proposed provisions should be modified to the following extent:

1. The $25,000 excess of deduction over gross income should be changed to $50,000 (proposed Code section 270(b)).
2. Wherever it appears throughout the section, the term "activity" should be changed to "trade or business."
3. The application of this proposal should be limited to individual taxpayers.

LIMITATION ON DEDUCTION OF INTEREST

We do not agree with the proposed limitation on the deduction of interest on funds borrowed for investment purposes. It has long been an established general principle of economics, accounting and taxation that express incident to the production of income are deductible from such income. This legislative proposal in a sense represents an artificial and arbitrary mutation of this principle which would tend to discourage the assumption of risk and the investment of capital—both of which have been important factors in the growth and development of our economic system. Furthermore, it would constitute an inconsistent exception to the cash receipts and disbursements method of accounting under which expenses are deducted when they are paid and income is taxed when it is received.

If, however, this proposed amendment of the Code is enacted in basically its present form, it is suggested that the limitation be made applicable at both the corporate and the shareholder level in the case of Subchapter S corporations.

MOVING EXPENSES

The Bill modifies the present treatment of job-related moving expenses by broadening the categories of deductible moving expenses, by providing that reimbursed employees are to be treated in the same manner as unreimbursed old employees and new employees, and by refining the requirements which must be met for the deduction to be available. We believe that the dollar limitations on amounts of certain of these deductions are unrealistic in today's economy and that they should be increased. We also believe that the deductions provided for should be extended to self-employed taxpayers and to partners.

Furthermore, we urge that the moving expense proposals be made effective for taxable years beginning on or after January 1, 1964.

LIMIT ON TAX PREFERENCES

The provisions of the Bill placing a limit on tax preferences would impose a tax by indirect means on amounts which presently are fully or partially tax exempt. We agree that public confidence in our self-assessment system is undermined by the ability of individuals to realize large amounts of disposable income with little, if any, payment of tax. However, we recommend that the tax preference items be dealt with through direct legislation. If this is not practicable, then we would support the provisions of the Bill with one modification. The tax preference item regarding the excess of accelerated depreciation over straight line depreciation should likewise provide for a reduction when straight line depreciation exceeds accelerated depreciation.

INCOME AVERAGING

Section 311 of the Bill would liberalize current law by reducing the requirements regarding the amount of income which qualifies for averaging and also, by broadening the types of income which are eligible for averaging.

We support this provision of the Bill but take exception to the proposed effective date of taxable years begining after December 31, 1969. We note that the provisions of the Bill dealing with the repeal of the alternative tax on capital gains for individuals (section 511) are to be effective with respect to sales and dispositions occurring after July 25, 1969. The effective dates of these two provisions coupled with the 10 percent tax surcharge now in effect subjects any long-term capital gain realized by individuals in the brief period from July 26 to December 31 to a severe and inequitable tax penalty. We believe equity dictates that the effective dates for eliminating the alternative capital gains tax and introducing the new averaging provisions be the same.

RESTRICTED PROPERTY

Section 321 of the Bill provides that a person who receives a beneficial interest in property by reason of services performed is to be taxed with respect to the property at the time it is received if he can transfer the property and if it is not subject to substantial risk of forfeiture. The tax will be on the amount by which the fair market value of the property exceeds the amount the employee paid for it.

At present the treatment of restricted property is governed by regulations which provide for no tax when the employee receives the restricted stock. When the restrictions lapse, the value of the stock at the time of transfer to the employee (determined without restrictions) is treated as compensation provided it has increased in value. If the value decreases, then the lower value is considered the compensation.

We support this provision on condition that any legislation finally approved continues to provide for the 50 percent maximum rate on earned taxable income. This provision, coupled with the capital gain provisions in the Bill, reflects a recognition of equality of tax treatment between earned income and capital gain income. We believe that these provisions, taken together will continue to provide incentive for those who have contributed much to our economic progress and will also lessen the search for transactions motivated by tax avoidance.

ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

We generally support the provisions of the Bill applicable to trusts except for effective dates. We recommend that the restrictive changes proposed with respect to accumulation trusts be made applicable only to those trusts established or additions made to the corpus of existing trusts after April 23, 1969.

With respect to eliminating the exceptions available under the definition of "accumulation distribution" as contained in present section 665(b) of the Code, it is recommended that for those accumulation trusts which cannot qualify under these exceptions, the effective date with respect to full or maximum throwback apply only to accumulations in fiscal years ending after April 23, 1969.

CORPORATE MERGERS

We disagree with section 411 of the Bill, which provides that a corporation is not to be allowed an interest deduction with respect to certain types of indebtedness. It is our view that any restrictions on the "tide of conglomerate mergers" should be imposed outside the tax law.

More specifically, we feel that the criteria contained in proposed Code sections 279 (b) and (c) are arbitrary and of doubtful validity, and the $5 million amount contained in proposed section 279(a) is discriminatory. Other difficulties may involve tracing problems and the question of what constitutes a "plan" of acquisition. Finally, the proposal will adversely affect persons who for valid business reasons may desire to sell their businesses. Such persons may be unable to realize a proper price because of the depressing effect of the proposal.

We disagree with section 412 of the Bill to the extent proposed section 453(b)(3) will disqualify from installment sale treatment transaction which presently have good business purpose. It would add more uncertainties to an already difficult area. Furthermore, problems presented by extensions, calls or other modifications are not covered. It is our view that proposed section 453(b)(4), with which we concur, is adequate to cover present abuses of the installment method.

We also do not agree with section 413 of the Bill regarding the tax treatment of original issue discount on bonds. We feel that the proposed changes violate the well-established rules of the cash method of accounting and further that they will add to complexity and information reporting difficulties far out of proportion to the problem which section 413 is designed to solve.

We recommend as an alternative solution of the problem that present Code section 1221 be amended to exclude from the definition of a capital asset all corporate nonconvertible debt (sometimes referred to as "straight" debt). Such a provision would make all gains and losses on sales of nonconvertible corporate debt ordinary income or ordinary deductions, respectively.

Nonconvertible corporate debt is acquired by an investor for the principal purpose of realizing a yield on the money invested. It appears that the market value of nonconvertible corporate debt obligations fluctuates in large measure with reference to prevailing interest yields. Accordingly, it seems reasonable to tax as ordinary income or allow as ordinary deductions gains or losses on disposition of the obligations which are primarily mere adjustments of yields.

We recognize that changes in market value of nonconvertible corporate debt can also be attributable to a change in the credit rating of the issuer, and it is true that it might be appropriate to reflect this element as capital gain or loss. However, on balance, we feel that the treatment of nonconvertible corporate debt as a noncapital asset will eliminate or reduce the importance of many complexities, including those resulting from sections 171 and 1232 of the Code.

NATURAL RESOURCES—MINERAL PRODUCTION PAYMENTS

We recommend that an exception to the treatment of mineral production payments as loans be made for production payments used to equalize the investment of participants in a unitization.

NATURAL RESOURCES—MINING AND EXPLORATION EXPENDITURES

We support the provisions of the Bill dealing with exploration expenditures. We suggest, however, that a provision be added to permit taxpayers who have made elections under present law to have additional time to make new elections. Present section 615(f) may prohibit this.

CAPITAL GAINS AND LOSSES

Section 514 of the Bill provides that long-term capital gain is to be a gain from the sale or exchange of a capital asset held for more than 12 months rather than the present 6 months. Gains realized on the sale or exchange of capital assets held for not more than 12 months are fully taxable as ordinary income.

Admittedly, the proposed 12 month holding period is arbitrary. We do feel however, that it is desirable to lengthen the six month period. We believe that a holding period beyond six months would more accurately indicate the intention to invest and thereby serve more closely Congressional intent that special tax treatment be afforded gains from investment as distinguished from speculative gains.

The effective date for the capital gain and loss provisions of the Bill is generally July 25, 1969. This date can impose serious tax penalties for those sales or dispositions which are made after July 25, 1969 pursuant to action taken prior to that date. We therefore suggest that the effective date be established at December 31, 1969, or, in the alternative, eliminate from the provisions of the Bill any transactions to which the seller was committed in writing on or before July 25, 1969. Further, we suggest that insofar as the repeal of the alternative capital gains tax for individuals and the character of the gain is concerned, collections or other dispositions in connection with transactions in which the installment method was elected should be treated as if they occurred on or before July 25, 1969.

SUBCHAPTER S CORPORATIONS

We have previously expressed our support for the principle of conforming the treatment of Subchapter S corporations more closely to that accorded partnerships, and we believe that an overall revision of the Subchapter S rules is desirable. The Bill's treatment of contributions to retirement plans in our judgment is an improper approach to only one Subchapter S corporation tax policy matter. We suggest that a better policy would be to amend the H.R. 10 rules to conform them more closely with those accorded corporations. Alternatively, no action should be taken on this matter until the overall revision of Subchapter S is further considered.

We suggest a more convenient method be provided for handling forfeitures applicable to contributions for years beginning after 1969.

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DETAILED ANALYSIS AND COMMENTS ON SELECTED PROVISIONS OF H.R. 13270

The detailed analysis contains our comments on selected provisions of H.R. 13270. Our failure to comment on certain sections of the Bill does not mean that we approve them. Generally, absence of comment means that we have not been able to arrive at a consensus.

SECTION 101 OF THE BILL—PRIVATE FOUNDATIONS

Proposed change

The Bill would provide rules for dealing with the following: tax on investment income, prohibitions on self-dealing, distributions of income, stock ownership limitation, limitations on use of assets, other limitations, disclosure and publicity requirements, change of status, changes in definitions, private operating foundation definition, and hospitals.

AICPA comments

While we agree with the intention of the Bill to curb abuses by private foundations, we are unable to express a consensus of opinion on the provisions of the Bill regarding private foundations. However, we do support the provision regarding self-dealing.

Generally, the provisions of the Bill regarding private foundations are so comprehensive and extremely complex that it is difficult to determine whether the abuses sought to be corrected will be accomplished without unnecessarily restricting appropriate activities of private foundations. Equally difficult to determine without extensive analysis are the socio-economic consequences which may result from enactment of the present provisions of this Bill.

Notwithstanding our inability to express a consensus of opinion on the private foundation provisions of the Bill, we hope that the following suggested modifications will assist your Committee as it considers these provisions.

SECTION 101(a) OF THE BILL; PROPOSED CODE SECTION 506

Tax on investment income

New section 506 of the Internal Revenue Code would provide for the imposition of a tax on the net investment income of every private foundation in an amount equal to 7½ percent of such income. The House Committee Report states that since the benefits of government are available to all, the costs should be borne at least to some extent by all of those able to pay and that this concept is as applicable to private foundations as it is to taxpayers generally. The Committee then goes on to state that appropriate assurances are needed that private foundations will promptly and properly use their funds for charitable purposes. This tax in their view is deemed in part as being a user fee.

If we accept the concept that this tax is needed for purely revenue purposes, it might be difficult to argue against its imposition. But, if we are more concerned with "assurances that private foundations will properly use their funds for charitable purposes," such aims can be attained by proper supervision, administration and review; and there is no need to impose any tax. If we accept the latter view, such a tax should not be imposed as it would deprive private foundations of funds that would otherwise be available for charitable purposes.

SECTION 101(a) OF THE BILL; PROPOSED CODE SECTION 507

Tax on the termination of private foundation status

Proposed Code section 507 provides in part that where there are willful repeated acts or a willful and flagrant act, the Internal Revenue Service can terminate the exemption of a private foundation. Under these circumstances there is a tax imposed on such an organization, the lower of either the "aggregate tax benefit" or the value of the net assets of such foundation. While it is difficult to object to the imposition of the proposed tax, where the foundation has been in existence for a number of years it would be a massive job to prepare all of the required computations for all the different years with the different tax brackets and tax rates in order to determine the "aggregate tax benefit." Subsection 507(e) provides for abatement, which under proper circumstances should provide sufficient protection against undue taxation.

SECTION 101(b) OF THE BILL; PROPOSED CODE SECTION 4942

Distributions of income

The tax on failure to distribute (proposed Code section 4942) requires that allowance for amounts set aside for future projects be established to the satisfaction of the Internal Revenue Service at the time they are set aside. In view of the penalties for failure to distribute, the Service will be able to prevent the setting aside of amounts merely by failing to act on applications or through the manner in which information supporting the amounts set aside is required to be filed. Foundations should be permitted to support these "set-asides" later.

SECTION 101(b) OF THE BILL; PROPOSED CODE SECTION 4943

Excess business holdings

There may be a conflict of interest in some situations where stock of a closely-held corporation is donated to a private foundation. This situation generally does not exist in a 20 percent ownership situation. Even if a 20 percent interest constitutes effective control, there is not necessarily any more conflict of interest between the donor and the foundation than between the donor and the other shareholders.

We believe, as did the Senate in 1950, that the loss to charity which will result from this approach will exceed any tax avoidance which may be eliminated. Elimination or extended deferral of income and estate tax deductions in the instances indicated will not only remove a factor which encourages contributions, but will also eliminate the ability of some individuals, such as business men who own little of value outside of their business interest, to make contributions.

Tables 10 and 11 (on pages 79 and 83) of the Treasury Department's Report on Private Foundations dated February 2, 1965 disclose that this proposal could affect 8 out of every 10 foundations in existence. Of more importance, these tables show that the performance of foundations with more than 20 percent donor-related influence over investment policy is generally just as good as that of foundations with a lesser degree of control. The following are some relevant ratios:

PERCENT OF DONOR-RELATED INFLUENCE OVER INVESTMENT

	Not over 20 percent	Over 20 percent	Over 50 percent
Ratio of market value of net assets to book value	144.0	141.0	132.0
Ratio of ordinary income to market value of net assets	4.0	3.5	3.5
Ratio of contributions received to market value of net assets	3.1	7.7	9.8
Ratio of grants made to market value of net assets	6.0	6.9	7.8
Ratio of grants made to ordinary income	151.0	197.0	222.0

We suggest that any rule restricting investment holdings be limited to 35 percent or more interests.

SECTION 101(b) OF THE BILL; PROPOSED CODE SECTION 4944

Investment jeopardizing exempt purpose

The prohibited transaction covered by this proposed new section of the Code substantially paraphrases the language contained in the present Code section 504(a)(3). In both cases the language is not precisely definitive and inadvertent violation could occur, since an investment that jeopardizes the exempt purpose is a highly subjective concept. The proposed penalty for an inadvertent error is too punitive and such a penalty should only be imposed after the expiration of a "correction period" of a nature similar to that set forth in proposed Code section 4941(e)(4).

SECTION 101(b) OF THE BILL; PROPOSED CODE SECTION 4946(a)(3)

Attribution rules

This proposed subsection provieds for the attribution rules of Code section 267(c) to apply to indirect stockholdings for the purposes of determining who is a "disqualified person" within the meaning of proposed Code section 4946(a). These attribution rules, and more specifically those of Code section 267(c)(3), are probably to broad and could result in violations from relatively minimal relationships. For example, Corporation A is a substantial contributor to Foundation F; X owns 50 percent and Y owns 1 percent of the combined voting power of A; X and Y, both individuals, are each 1 percent partners in a widely-held joint venture. Y has no other relationship with X, A or F, and yet it appears that he would be considered to be a "disqualified person" with respect to F.

It is suggested that the attribution rules of Code section 318(a) be substituted for those of section 267(c). In the alternative, it is suggested that the attribution rules of section 267(c)(3) only apply to partners with a partnership interest of 10 percent or more.

SECTION 121 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 512 AND 514

Exempt organizations debt-financed property

Present law.—Under present law, charities and some of the other types of exempt organizations are subject to tax on rental income from real property to the extent the property was acquired with borrowed money. However, this provision does not apply to all tax-exempt organizations and there is an important exception which excludes rental income from a lease of 5 years or less. Nor does the tax apply to income from the leasing by a tax-exempt organization of assets constituting a going business.

As a result some tax-exempt organizations have used their tax-exempt privileges to buy businesses and investments on credit.

Proposed change

The Bill amends the Code to provide that all exempt organizations' income from "debt-financed" property is to be subject to tax in the proportion the property is financed by dept. Thus, for example, if a business or investment property is acquired subject to an 80 percent mortgage, 80 percent of the income and 80 percent of the deductions are taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes. Capital gain on the sale of debt-financed property is also taxed. The amendment makes exceptions for property to be used for an exempt purpose within a reasonable time, and also for property acquired by gift or inheritance under certain conditions.

AICPA comments—General

The Supreme Court desicision in the *Clay B. Brown* case has focused attention on an abuse of tax exemption for foundations through their activities in debt financing of acquisitions.

The problems which may arise in borrowing by foundations for investment purposes are:

1. Private parties are able to shift a substantial measure of the financial benefit of the foundation's tax exemption to themselves (the so-called "bootstrap" sale); and

2. The private foundation can convert its tax exemption into a self-sufficient device for the production of capital, thereby serving itself from reliance upon contributions and eliminating the healthful scrutiny of its activities which is implicit in such reliance.

It is believed that H.R. 13270 goes significantly beyond what is necessary to deal with a Clay Brown-type transaction. It embraces the concept that virtually *any* type of income derived by an exempt organization from the use of borrowed funds should be taxed differently than the same or similar income derived from the use of corpus.

We urge that the scope of the Bill be limited to the avowed purpose of extending the unrelated business taxable income concept to income arising from Clay Brown-type transactions. Thus, the present exemption from tax on unrelated business income for rents from personal property leased with realty could be eliminated assuming the personal property constitutes more than an incidental or insubstantial portion of the property subject to the lease. In effect, the leasing of personal property wold be treated as an unrelated trade or business.

The following comments are submitted in the event that your Committee believes the "Clay Brown" provisions of H.R. 13270 should be enacted substantially as passed by the House. As indicated above, we believe that the general scope of this legislation is too broad.

Specific comments

Proposed code sections 514(a)(1), 514(b)(1) and 514(c)—General

The proposed rules may subject an exempt organization to a tax liability under circumstances where no tax avoidance or genuine "debt-financed" acquisition is involved, and where we are sure no tax is intended to apply. Assume that an individual owns stock (or land, or any other property) with a basis of $3,000, subject to a loan (less than 5 years old) of $3,000, with a current value of $10,000. He makes a charitable contribution of the property subject to the loan. The recipient charity puts the property up for sale promptly. In due course it is sold, the loan paid, and the remaining proceeds (the charitable contribution received) applied to charitable purposes. There will be a basis of $3,000 and an acquisition indebtedness of $3,000. The percentage described in section 514(a)(1) will be 100 percent. The gain of $7,000 ($10,000 proceeds less $3,000 basis) will therefore be fully taxable—surely an unintended result. The same result might even follow in the frequently arising situation where a charitable donor sells property, to a charity at a bargain price. The purchase price itself, if it remains unpaid for only a few days, could be "acquisition indebtedness." To prevent this result, it should be provided that property acquired by gift, inheritance or bargain purchase shall not be treated as "debt-financed property" if the exempt organization, within a short time after acquisition, takes bona fide steps to dispose of the property and does in fact dispose of it within a time which is reasonable, taking into account the nature of the property.

PROPOSED CODE SECTION 514(C)(7)

Acquisition indebtedness

In computing the percentage of any gain or loss to be taken into account upon a sale or other disposition of debt-financed property, the term "average acquisition indebtedness" should be defined in a manner parallel to that in which it is defined for other purposes, i.e., the average amount of the acquisition indebtedness during the 12-month period ending with the date of the sale or other disposition. It appears inequitable to use the highest amount of acquisition indebtedness during the 12-month period.

PROPOSED CODE SECTION 514(B)(2)

Definition of debt-financed property

The requirement that the tax be paid currently subject to later refund if the conditions of proposed section 514(b)(2)(B) are met, may harm some exempt organizations. For example, a university may be struggling under the financial burden of relocating its campus, or may be establishing another campus, and cannot meet the "neighborhood test." It does actually satisfy the "use test" within ten years. If the university must pay tax on income earned from the property, it may be seriously handicapped if it depends upon the earnings to help finance the project. The later refund does not make the university whole, because it may have needed the money earlier. It is suggested that where the circumstances contemplated by subparagraphs (B) and

(D) arise, provision be made for disclosure requirements, for holding open the statute of limitations for assessment and for payment of the tax if the conditions are ultimately not met. Interest at the rate of 6 percent would, of course, be payable.

PROPOSED CODE SECTION 514(b)(2)(D)

Definition of debt-financed property

If this section is not revised in accordance with the immediately preceding recommendation, the rate of average amount of the acquisition indebtedness during the 12-month period ending with the date of the sale or other disposition. It appears inequitable to use the highest amount of acquisition indebtedness during the 12-month period.

PROPOSED CODE SECTION 514(b)(2)

Definition of debt-financed property

The requirement that the tax be paid currently subject to later refund if the conditions of proposed section 514(b)(2)(B) are met, may harm some exempt organizations. For example, a university may be struggling under the financial burden of relocating its campus, or may be establishing another campus, and cannot meet the "neighborhood test." It does actually satisfy the "use test" within ten years. If the university must pay tax on income earned from the property, it may be seriously handicapped if it depends upon the earnings to help finance the project. The later refund does not make the university whole, because it may have needed the money earlier. It is suggested that where the circumstances contemplated by subparagraphs (B) and (D) arise, provision be made for disclosure requirements, for holding open the statute of limitations for assessment and for payment of the tax if the conditions are ultimately not met. Interest at the rate of 6 percent would, of course, be payable.

PROPOSED CODE SECTION 514(b)(2)(D)

Definition of debt-financed property

If this section is not revised in accordance with the immediately preceding recommendation, the rate of organization as to which nonrelated rentals are incidental and possibly temporary in nature. Therefore, we recommend that the word "substantially" be inserted before the word "all" in the first line of proposed section 514(b)(1)(A).

SECTION 121 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 511 AND 513

Exempt organizations—Extension of unrelated business income tax

Present law.—Under present law the tax on unrelated business income applies only to certain tax-exempt organizations. These include:

1. Charitable, educational, and religious organizations (other than churches or conventions of churches);
2. Labor and agricultural organizations;
3. Chambers of commerce, business leagues, real estate boards, and similar organizations;
4. Mutual organizations which insure deposits in buildings and loan associations and mutual savings banks; and
5. Employees' profit sharing trusts and trusts formed to pay (nondiscriminatory) supplemental unemployment compensation benefit.

Proposed change.—The Bill extends the unrelated business income tax to all exempt organizations (except United States instrumentalities created and made tax exempt by a specific act of Congress). The organizations which will newly be made subject to this tax include churches and conventions or associations of churches, social welfare organizations, social clubs, fraternal beneficiary societies, voluntary employees' beneficiary organizations, teachers' retirement fund associations, benevolent life insurance associations, cemetery companies, credit unions, mutual insurance companies, and farmers cooperatives formed to finance crop operations.

As under present law, in general this tax does not apply unless the business is "regularly carried on" and therefore does not apply for example in cases where income is derived from an annual athletic exhibition. Under the amendments made by the Bill, in the case of any membership organization, any income resulting from charges to the members for goods, facilities, and services supplied in carrying out the exempt function is not subject to tax.

The Bill contains several administrative provisions including one providing that no audit of a church is to be made unless the principal Internal Revenue officer for the region believes that the church may be engaged in a taxable activity. Churches will not be subject to tax for six years on businesses they now own.

AICPA comments.—We believe that the principal aim of any reform in the tax treatment of exempt organizations should be to make sure that they shall have neither an advantage nor a handicap in those operations in which they are competing with taxpaying organizations. The Congress has long recognized that a tax-exempt organization has an inherent advantage over a taxpaying organization if both are competing in the same field. Therefore, in 1950, Congress enacted a tax on the unrelated business income of some but not all exempt organizations.

H.R. 13270 provides that the unrelated business income tax be extended to apply to a number of additional types of exempt organizations. These include churches (or associations of churches), social welfare organizations, social clubs, and fraternal beneficiary societies. Certain exceptions and limitations are provided in each case to protect exempt activities from taxation.

We support these provisions. There appears to be no reason why a church, for example, should be permitted to engage in activities not related to its exempt purposes so as to compete on a tax-exempt basis with a taxpaying enterprise. Any such tax preference tends to impair the proper working of our free market economy which is based on open and fair competition.

Section 121(b) of the Bill; Proposed Code Section 512(a)(3)

Social clubs.—At present social clubs are not subject to the unrelated business income tax. An incidental sale of property will not deprive the social club of its exemption, but a club which regularly receives income from sources other than its membership will generally lose its exemption regardless of whether the outside income is from investments or from a business activity. Thus, social clubs which receive any nonmembership income are currently in an all-or-nothing quandary. If the outside income is an incidental item the club remains exempt and the outside income escapes taxation. If the item is more than incidental the club becomes fully taxable. It is often hard to draw the dividing line.

The Bill provides that social clubs be taxed on all their income, whether from investments or other sources, except that which is derived from the members in return for the club's services as a social club. The proposed taxation of investment income is intended to prevent untaxed investment income from indirectly inuring to the members' benefit by subsidizing the club's services to the members.

We support this provision subject to the following recommendations:

1. The Bill would allow as deductions, items *directly* connected with an activity generating income subject to tax. This could give rise to considerable controversy as to what is directly connected. In any case it is inequitable because clearly a portion of the indirect or overhead expenses of the club are also connected with the income subject to tax. Accordingly, the deductible items should be defined as including direct expenses and allocable portion of the indirect or overhead expenses.
2. It should be made clear that a club is entitled to the same deductions as any other taxpayer with respect to its income subject to tax. Thus, it should be entitled to deductions for depreciation, interest, taxes, repairs, etc., with respect to rental income; the dividends received deduction; and to deduct all expenses connected with income-producing property. It should also be made clear that clubs are entitled to the benefit of the tax-free exchange provisions and the involuntary conversion provisions.
3. If a club disposes of the property used in its social functions, either to move to a new location or to construct new facilities, it should not be taxed on the gain from such disposition so long as the proceeds are reinvested in other facilities to be used in its social functions.

Section 121(b) of the bill; proposed code section 512(b)(12) limit on specific deduction

We recommend that the specific deduction under section 512(b) (12) be raised from $1,000 to $5,000. This will recognize the inflation that has occurred since enactment of the tax on unrelated business income and eliminate the compliance burdens of exempt organizations having similar amounts of unrelated income.

(See Technical Information Release No. 899, April 14, 1967, which announced the proposed regulations under sections 512 and 513 and indicated that the Internal Revenue Service would consider the appropriateness of a legislative recommendation to make the tax inapplicable where only "small" amounts of unrelated income are involved.)

Section 121(b) of the bill; proposed code section 512(b)(15) special rules for certain organizations

Under proposed Code section 512(b)(15), passive type income received from organizations over which the recipient exempt organization has control (as defined in section 368(c)) are included in the exempt organization's unrelated taxable income. This 80 percent control requirement may not be sufficiently stringent to carry out the Congressional purposes since it may permit easy avoidance. A lower percentage may be appropriate.

SECTION 121—PROPOSED AMENDMENT TO CODE SECTION 512

Exempt organizations—Taxation of investment income of social, fraternal and similar organizations

Present law.—Under present law the investment income of social clubs fraternal beneficiary societies and voluntary employees' beneficiary associations are exempt from income tax.

Since the tax exemption for social clubs, fraternal beneficiary societies and voluntary employees' beneficiary associations is designed, at least in part, to allow individuals to join together to provide recreational or social facilities without tax consequences, the tax exemption operates properly only where the sources of income of the organizaiton are limited to receipts from the membership. Where an organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit from the tax-exempt funds used to provide pleasure or recreational facilities.

Proposed change.—The Bill provides for the taxation (at regular corporate rates) of the investment income and other unrelated income of social clubs, fraternal beneficiary associations, and voluntary employees' beneficiary associations. This will not apply, however, to such income of fraternal beneficiary associations and voluntary employees' beneficiary associations to the extent it is set aside to be used only for the exempt insurance function of these organizations and for charitable purposes.

If in any year an amount is taken out of the set-aside and used for any other purpose, the amount taken out will be subject to tax in such year.

We support this proposed amendment to the Code.

SECTION 121 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 512

Exempt organizations—interest, rent and royalties from controlled corporation

Present law.—Under present law, rent, interest and royalty expenses are deductible in computing the income of a business. On the other hand, receipt of such income by tax-exempt organizations generally is not subject to tax.

Some exempt organizations "rent" their physical plant to a wholly-owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables the taxable corporation to escape nearly all of its income taxes because of the large "rent" deduction.

Proposed change.—The Code would be amended to provide that in any case in which an exempt organization owns more than 80 percent of a taxable subsidiary, interest, annuities, royalties and rents are to be treated as "unrelated business income" and subject to tax. The deductions connected with production of such income are allowed.

We support this proposed amendment of the Code.

SECTION 121 OF THE BILL—PROPOSED CODE SECTION 278

Exempt organizations—limitation on deductions of nonexempt membership organizations

Present law.—Some courts have held that taxable membership organizations cannot create a "loss" by supplying their members services at less than cost.

Other courts have held instead that such a "loss" is permissible. The expenses of providing such services at less than cost will offset from taxation additional income earned by the organization from investments or other activities.

Proposed change.—The House Bill provides that in the case of a taxable membership organization the deduction for expenses incurred in supplying services, facilities or goods to members is allowed only to the extent of the income from such members.

We support this proposed amendment of the Code.

SECTION 121 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 513

Exempt organizations—Income from advertising, etc.

Present law.—Late in 1967 the Treasury promulgated regulations under which the income from advertising was treated as "unrelated business income" even though such advertising appeared, for example, in a periodical related to the educational or other exempt purpose of the organization.

The statutory language on which the regulations were based was sufficiently unclear so that substantial litigation could have resulted from these regulations.

Proposed change.—The House Bill provides that income from advertising (or a similar activity) is included in unrelated business income even though the advertising is carried on in connection with activities related to the exempt purpose.

AICPA comments—General

The primary purpose of the tax on unrelated business income originally was to deal with the problem of unfair competition. The tax-free status of certain exempt organizations enabled them to use their tax-free profits to expand operations, while their competitors could expand only with profits remaining after taxes. (See House Committee Report No. 2319, Eighty-first Congress, Second Session, accompanying the Revenue Act of 1950, which initially introduced the statutory predecessor of section 513 of the current Code, 1950-2 C.B. 429.)

While the 1950 House Report makes it clear that the intent of section 513 was to meet the problem of unfair competition, the statute itself is not in terms of unfair competition, but rather imposes a tax on the "unrelated business income" of certain organizations. Thus, Congress, in 1950, seems to have concluded that a business that is unrelated to the exempt purposes of an organization presents unfair competition. Conversely, a business that is related to the exempt purposes should not be regarded as presenting unfair competition. Nevertheless, the Treasury Department concluded otherwise when it adopted regulations under section 513 on December 11, 1967. The House Committee on Ways and Means agrees with that conclusion and with the purpose of the regulations. On page 50 of its report, (No. 91-413-Part 1) the Committee makes this statement: "In general, it (the Committee) is in agreement with the purpose of the regulations. Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. It has concluded that by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore it believes this income should be taxed." Accordingly, the House apparently agrees with the Treasury's Example (7) in Regulation Section 1.513-1(d)(4)(iv), which states that advertising income derived by an exempt organization is taxable under the following circumstances:

1. The organization is formed to advance the interests of a particular profession and draws its membership from members of that profession.
2. A monthly journal is published containing articles and other editorial material which contribute importantly to the accomplishment of the purposes for which exemption has been granted.
3. The journal's advertising promotes *only* products which are within the general area of professional interest of the organization's members.

The Treasury Department concedes that income from the sale of subscriptions to members and others, in accordance with the organization's exempt purposes, does not constitute gross income from an unrelated trade or business. However, the following fallacious conclusions are drawn with respect to the income from the limited type of advertising described in item 3, above:

"Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and its method. Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business. . . ."

We believe that this interpretation and the conclusions of the House Ways and Means Committee, quoted above, suffer from inaccurate analysis on the following three counts:

1. Advertising that promotes *only* products or services of professional interest is functionally the same as editorial content that is concerned only with matters of the same professional interest (including, of course, articles that may discuss certain of these products or services). Since such editorial content is acknowledged to contribute importantly to the accomplishment of exempt purposes, the same characterization can be attributed to such functionally related advertising. They are both *related* to the activities of the organization.

2. It is highly unrealistic to categorize an *interdependent* economic activity, such as the sale of space in a publication, as a trade or business.

3. Unfair competition, which was the problem intended to be solved by the Revenue Act of 1950, appears to be completely absent under the illustrative facts.

Specific legislative recommendations

We believe that Code section 512 and/or section 513 should be amended to incorporate the following concepts:

1. A "trade or business" should be defined along vertically integrated lines so that advertising activity, alone, cannot constitute a trade or business.

2. In order to avoid characterization as unrelated business income, *all* activities of such defined trade or businesses must be functionally related to the purposes for which an organization has been granted exemption.

Advertising income should not give rise to unrelated business income under the following circumstances:

1. The income is derived from magazines and other periodicals published by exempt organizations.

2. The publication's editorial matter and advertising are substantially related to purposes for which the organization has been granted exemption.

These criteria should considerably ease any anticipated enforcement burdens of the Internal Revenue Service since compliance with such standards could be easily observed by Service office personnel. For example, a centralized unit of the Service should be furnished with all exempt organization publications and could determine, through physical inspection, whether the necessary editorial and advertising policies are being maintained.

The *de minimis* rule provided by Code section 512(b)(12), allowing a $1,000 specific deduction, should be expanded in order to eliminate the tax where annual unrelated business income does not exceed $5,000. (See Technical Information Release No. 899, April 14, 1967, which announced the proposed regulations under sections 512–513 and indicated that the Internal Revenue Service would consider the appropriateness of a legislative recommendation to make the tax inapplicable where only "small" amounts of unrelated income are involved.)

In addition, where the unrelated business income tax is imposed, net operating loss carrybacks and carryovers should be allowed to the same extent as in the case of nonexempt entities conducting competitive operations. Compare the limitations set forth in Regulations Section 1.512(a)-1(d)(2)(ii) and (e), Example (2).

The following three examples are provided to illustrate the effect of the concepts which we propose be incorporated into the statute to deal with the tax treatment of advertising income derived by exempt organizations:

Examples of effect of legislative recommendations

Example (1): No unrelated business income resulting from related editorial and advertising content.—Z is an association exempt under section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession. Continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption.

Z publishes a monthly journal containing articles and other editorial material which contribute importantly to the accomplishment of purposes for which exemption is granted the organization.

The advertising in Z's journal promotes products which are within the specialized area of professional interest of Z's members. Since the advertisements contain information dealing with professional interest and development, their informational function is identical to the function of the editorial content. Accordingly, the publication of advertising designed and selected in this manner, pursuant to Z's advertising policies, is an educational activity of the kind contemplated by the exemption statute.

Therefore, Z's publication of advertising also contributes importantly to the accomplishment of its exempt purposes; and the income which it derives from its publishing business, attributable to *both* literary and advertising activities, does not constitute gross income from an unrealted trade or business.

Example (2): Unrelated business income resulting from unrelated literary activity.—Assume the same facts as in the preceding example, except that the editorial content of Z's journal is not exclusively devoted to professional matters since news and features covering domestic politics, foregn affairs and sports events are also published. This nonprofessional content is of a general nature, appealing to members of the particular profession involved as well as to the laity comprising the balance of our national population. Accordingly, the publication of this type of literary material is not designed nor selected to further Z's exempt purposes and would thus compete with other generalized magazines published by taxable organizations. Such editorial content is not an educational activity of the kind contemplated by the exemption statute.

Therefore, Z's publication of such literary material does not contribute importantly to the accomplishment of its exempt purposes: and the income which it derives from its publishing business, attributable to *both* literary and advertising activities, constitutes gross income from an unrelated trade or business.

Example (3): Unrelated business income resulting from unrelated advertising activity.—Assume the same facts as in Example (1), except that Z also derives income from the sale of space in its journal for general consumer advertising, including advertisements of such products and services as soft drinks, automobiles, wearing apparel, home appliances and vacations arranged by travel agencies.

The publication of such advertisements does not contribute importantly to the accomplishment of any purpose for which exemption is granted and would thus compete with the advertising activity of magazines published by taxable organizations. Consequently, the income derived from Z's publishing business, attributable to *both* literary and advertising activities, constitutes gross income from an unrelated trade or business.

SECTION 201(A) OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 170(B)

Charitable contributions—50-percent charitable deduction limitation

Present law.—Under present law, the charitable contributions deductions allowed individuals generally is limited to 30 percent of the taxpayer's adjusted gross income. In the case of gifts to certain private foundations, however, the deduction is limited to 20 percent of the taxpayer's adjusted gross income.

Proposed change.—The bill increases the general limitation on the charitable contributions deduction for individual taxpayers from 30 percent of adjusted gross income to 50 percent of their contribution base. The 20-percent charitable contribution deduction limitation in the case of gifts to certain private foundations is not increased by the Bill. Also, contributions of appreciated property (which property, if sold, would be treated as giving rise to capital gain) is to be subject to the 30-percent limitation.

We support this proposed amendment to the code.

SECTION 201(A) OF THE BILL—PROPOSED REPEAL OF CODE SECTION—170(B)(1)(C)

Charitable contributions—Repeal of unlimited charitable deduction

Present law.—An individual taxpayer is presently allowed an unlimited charitable deduction if in the current taxable year and in 8 of the preceding 10 taxable years the total of the taxpayer's charitable contributions plus income taxes (determined without regard to the tax on self-employment income) exceeds 90 percent of his taxable income (computed without regard to the charitable contributions deduction, personal exemptions and net operating loss carrybacks).

Proposed change.—The bill would phase out the unlimited charitable contributions deduction over a 5-year period covering taxable years beginning in 1970 through 1974.

We support this proposed amendment to the code.

SECTION 201(a) OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 170(b)

Disallowance of charitable deduction for gift of use of property

Present law.—Presently a taxpayer may take a charitable deduction for the fair-rental value of property which he owns and gives to a charity to use for a specified time period. In addition he excludes from his income the income he would have received had the property been rented.

Proposed change.—H.R. 13270 provides that a charitable deduction is not to be allowed unless the taxpayer's entire interest in the property is donated. Therefore, no deduction will be allowed for the right to use property for a period of time. The taxpayer, however, will continue to be able to exclude from income the value of the right to use property so contributed.

We support this proposed amendment to the code.

SECTION 201(c) OF THE BILL—PROPOSED AMENDMENT OF CODE SECTION 170 AND ADDITION OF NEW SECTION 83

Charitable contributions of appreciated property

Present law.—A taxpayer who contributes to charity property which has appreciated in value generally is allowed a charitable contribution deduction for the fair market value of the property at the time of contribution (subject to certain technical recapture provisions), and no income tax is imposed on the appreciation in value of the property at the time of the gift.

Proposed change.—H.R. 13270 proposes to eliminate some of the present tax advantage of contributing appreciated property to certain private foundations by requiring the donor of such property to elect either to reduce his charitable contribution deduction to the amount of his cost or other basis for such property *or* to take a charitable contribution deduction based on the fair market value of the property but to include in his tax base the untaxed appreciation with respect to the property involved. The charitable donee's basis for the property would be the donor's adjusted basis (for purposes of determining gain increased by the amount of gain recognized by the donor with respect to the contribution).

Under the bill, the same treatment would be applicable without regard to the type of charitable recipient, to:

1. All gifts of property if any portion of the gain on the property (had it been sold) would have resulted in either ordinary income or short-term capital gain;
2. All charitable gifts of works of art, collections of papers and other forms of tangible personal property (fixtures which are intended to be severed from real property are to be treated for this purpose as tangible personal property); and
3. All charitable gifts of future interests in property.

AICPA comments.—Although we have not been able to reach a consensus on all of the bill's proposals with reference to charitable contributions of appreciated property, we do agree contributions of such property should be treated in the same manner without regard to the type of charitable recipient.

SECTION 201(d) OF THE BILL—PROPOSED AMENDMENT OF CODE SECTION 1011

Charitable contributions—Bargain sales to charitable organizations

Present law.—If property is sold to a charity at a price below its fair market value, the proceeds of sale are considered to be a return of the cost and are not required to be allocated between the cost basis of the "sale" part of the transaction and the "gift" part. The seller is allowed a charitable contribution deduction for the difference between the fair market value of the property and the selling price.

Proposed change.—The bill provides that the cost or other basis of the property is to be allocated between the portion of the property "sold" and the portion of the property "given" to the charity on the basis of the fair market value of each portion.

We support this proposed amendment of the code.

SECTION 201(f) OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 642(c)

Charitable contributions for estates and trusts

Present law.—A nonexempt trust (or estate) is allowed a full deduction for any amount of its gross income which it pays or which it permanently sets aside for charitable purposes. There is no limitation on the amount of this deduction.

H.R. 13270 provides that an individual who establishes a trust to pay the income to a private person for a period of years with the remainder to go to charity is to be allowed a charitable deduction with respect to the charitable remainder interest only if the trust qualifies as a charitable remainder trust. It is also provided that no deduction is to be allowed for a charitable gift of an income interest in trust unless the individual making the gift is taxable on the trust income.

It would be inconsistent with these rules to continue to allow a trust a deduction for amounts set aside for charity. Such a deduction is unnecessary in the case of a charitable remainder trust since such a trust is to be tax exempt. In other cases, the allowance of a set-aside deduction would be inconsistent with the limitation to be placed on charitable gifts in trust.

Proposed change.—For the reasons discussed above, the bill eliminates the so-called set-aside deduction presently allowed trusts (or estates). However, in computing its taxable income, a non-exempt trust will still be allowed to deduct any amount of its gross income, without limitation, paid as a charitable contribution. In addition, to enable the trustee to act after he knows the income for the year precisely, the bill allows a trustee to make a contribution in the next following taxable year and elect to treat such contribution as made during the taxable year. As under existing law, proper adjustment is to be made for charitable contributions paid out of capital gain income and the deduction is not to diminish the unrelated business income of the trust, if any. Furthermore, the nonexempt trust is to be subject to the same restrictions as a private foundation if it makes charitable contributions.

We support this proposed amendment to the code.

SECTION 201(g) OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 673(b)

Charitable contributions—Repeal of 2-year charitable trust rule

Present law—Under present law, an individual may establish a trust to pay the income from his property, which he transfers to the trust, to a charity for a period of a least 2 years, after which the property is to be returned to him. Although the individual does not receive a charitable contribution deduction in such a case, the income from the trust property is not taxed to the individual. This 2-year charitable trust rule is an exception to the general rule that the income of a trust is taxable to the person who establishes the trust where he has a reversionary interest in the trust which will or may be expected to take effect within 10 years.

The effect of the special 2-year charitable trust rule is to permit charitable contribution deductions in excess of the generally applicable percentage limitations of such deductions.

Proposed change.—In order to prevent circumvention of the generally applicable percentage limitations on the charitable contribution deduction, the House Bill would repeal the 2-year trust provision of Code section 673(b). Accordingly, an individual no longer will be able to exclude income from property placed in a trust (to pay the income to a charity for a period of at least 2 years) from his income. As a result, a person who establishes a trust will be taxable on its income, whether or not the income beneficiary is a charity, where the individual has a reversionary interest which will or may be expected to take effect within 10 years from the time the income-producing property is transferred to the trust.

We support this proposed amendment to the Code.

SECTION 210 (a) AND (h) OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 170(b) AND 2522(c)

Charitable income trusts with noncharitable remainder

Present law.—Under present law, a taxpayer who transfers property to a trust to pay the income to a charity for a period of years with the remainder to go to a noncharitable beneficiary, such as a friend or member of his family, is allowed a charitable contribution deduction for the present value of the income interest given to the charity. In addition, neither he nor the trust is taxed on the income earned by the trust.

A taxpayer receives a double tax benefit where he is allowed a charitable contribution deduction for the present value of an income interest in trust given to charity and also is not taxed on the income earned by the trust. In fact, this double benefit allows a taxpayer to increase his after-tax cash position by postponing a planned noncharitable gift

Proposed change.—The bill provides that a charitable contribution deduction is not to be allowed for an income interest given to charity in trust, unless the grantor is taxable on the income of the trust or unless all the interests in the trust are given to charity. The effect of this is to deny the double benefit of a deduction and exemption from taxation which is available under present law.

The bill also provides that a charitable deduction will not be allowed for an income interest given to charity in trust unless either the interest is in the form of a guaranteed annuity or the trust instrument specifies that the charitable income beneficiary is to receive a fixed percentage annually of the fair market value of the trust property (as determined each year). The purpose of this rule is to assure that the amount received by the charity in fact bears a reasonable correlation to the amount of the charitable contribution deduction allowed the taxpayer.

If a taxpayer, who is allowed a charitable deduction under the above rules for an income interest transferred in trust to charity, subsequently ceases to be taxable on the trust income, he would receive a double tax benefit with respect to the future trust income—he would not be taxed on that income but would have received a charitable deduction with respect to it. To prevent this result, the bill, in effect, provides for the recapture of that part of the charitable contribution deduction previously received by the taxpayer with respect to the income of the trust which will go to the charity but on which he will not be taxed.

We support these proposed amendments to the Code.

SECTION 201(e). (h) AND (i) OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 170(h), 2055(e), 2106(a) AND 2522(c) AND PROPOSED CODE SECTION 664

Charitable contributions—Charitable remainder trusts

Present law.—An individual may now make a charitable contribution by transferring property to a trust and providing that the trust income be paid to designated private persons for a period of time with the remainder to go to a charity. The amount of the deduction is based upon the present value of the remainder interest at the time of the gift.

Under the present rules it is possible for a taxpayer to receive a deduction for a contribution of a remainder interest to a charity which may be greater than the amount the charity ultimately receives. This is possible because the trust assets may be invested in a manner which maximizes income at the expense of capital.

Proposed change.—To prevent the above situation the Bill provides that no deduction will be allowed for gifts of a remainder interest unless the trust specifies that the noncharitable income beneficiary is to receive either a stated annual dollar amount or a fixed percentage of the value of the trust assets.

We support these proposed amendments to the Code.

SECTION 211 OF THE BILL—PROPOSED CODE SECTION 1251

Farm losses

Present law.—Under present law, income or losses from farming may be computed under more liberal accounting rules than those generally applicable to other types of businesses. A cash method of accounting under which costs are deducted currently may be used, rather than an inventory and ~~accrual method~~ under which the deduction of costs would be postponed. In addition, a taxpayer in the business of farming may deduct expenditures for developing business assets (such as raising a breeding herd or developing a fruit orchard) which other taxpayers generally have to capitalize. Furthermore, capital gain treatment often is available on the sale of farm assets.

The combination of current deductions of farm expenses of a capital nature from ordinary income with future capital gain treatment on the sale of farm assets may produce significant tax savings.

Proposed change.—The bill generally provides that gain on the sale of certain farm property is to be treated as ordinary income to the extent of the taxpayer's previous farm losses. For this purpose, a taxpayer must maintain an excess deductions account to record his farm losses. In the case of individuals, farm losses must be added to the excess deductions account only if the taxpayer has more than $50,000 of nonfarm income for the year and, in addition, only to the extent his farm loss for the year exceeds $25,000. The amount in a taxpayer's excess deductions account would be reduced by the amount of farm income in subsequent years.

The amount of farm losses recaptured on a sale of farm land would be limited to the deductions for the taxable year and the four previous years with respect to the land for soil and water conservation expenditures and for land clearing expenditures.

To the extent gain on the sale of farm property is treated under these rules as ordinary income, this would reduce the amount in the taxpayer's excess deductions account.

The recapture rules provided by the bill would not apply if the taxpayer elected to follow generally applicable business accounting methods (i.e., if he used inventories and capitalized capital expenditures).

AICPA comments.—We agree with the intended purpose of the proposed legislation which is to curb abuses of capital gain provisions in the farming segment of the economy.

Section 211 of the bill seeks to solve this problem by denying capital gain benefits in the case of the disposition of farm property unless the taxpayer (1) accounts for inventories, and (2) capitalizes all expenditures properly chargeable to a capital account. The de minimis exception (later commented on) appears to be reasonable to limit the application of Section 211 to taxpayers who could otherwise abuse capital gain benefits.

On the other hand, we believe that the language of Section 211 is so sweeping that it will affect more taxpayers than intended. Section 211 applies to all taxpayers who, with respect to any taxable year, (1) incur a farm net loss, *or* (2) have a balance in the excess deductions account at the close of the taxable year. Addition to the excess deductions account for a current year's farm loss is not required if (1) nonfarm adjusted gross income is $50,000 or less, and (2) the farm net loss is $25,000 or less. However, it appears that the $50,000/$25,000 de minimis exceptions do not apply to excuse application of Section 211 in the face of a current year's loss, no matter how small (proposed Code section 1251(a)(1)). Should this be the case, Section 211 would apply to all taxpayers incurring a current farm loss, with the result that a great many farmers would be faced with loss of capital gain benefits if they did not elect to adopt certain accounting methods. To remedy this apparent defect, we recommend that the bill be clarified so that there is no doubt that the $50,000/$25,000 de minimis exceptions apply also in the case of farm net losses for the current taxable year.

In order not to discourage taxpayers from changing to the accounting methods described in proposed Code section 1251(b)(4)(A), it is suggested that section 1251(b)(4)(C) provide that additions to taxable income resulting from the change could be spread over a 10-year period, at the election of the taxpayer. This type of provision has been helpful in Internal Revenue Service administration of other changes in accounting methods and practices, and should be advantageous to both taxpayers and the Government in this connection.

SECTION 213 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 270

Hobby losses

Present law.—Present law contains a so-called hobby loss provision which limits to $50,000 per year the amount of losses from a "business" carried on by an individual that he can use to offset his other income. The limitation only applies, however, if the losses from the business exceed $50,000 a year for at least five consecutive years. Moreover, certain specially treated deductions are disregarded in computing the size of the loss for this purpose.

Proposed change.—The bill replaces the present hobby loss provision with a rule which provides that items attributable to an activity shall be allowed only to the extent of the gross income from such activity unless such activity is carried on with a reasonable expectation of realizing a profit. If the deductions attributable to an activity exceed the gross income from such activity by $25,000 or more for any 3 of 5 consecutive years ending with the taxable year, then unless the taxpayer establishes to the contrary, the activity shall be deemed to have been carried on without a reasonable expectation of realizing a profit.

AICPA comments.—We agree with the intended purpose of the proposals which are aimed at making the application of Code Section 270 (as amended) more effective.

It does appear, however, that the proposed provisions should be modified to the following extent:

1. The $25,000 excess of deduction over gross income should be changed to $50,000. (section 270(b)).
2. Wherever it appears throughout the section, the term "activity" should be changed to "trade or business."
3. The application of this section should be limited to individual taxpayers.

It is our belief that the disallowance of losses using the $25,000 limitation is too harsh considering that the entire loss would be disallowed. Moreover, in these times of inflation, the $25,000 limitation does not seem realistic where new business ventures are undertaken. Small taxpayers often lose more than $25,000 in three out of five years (particularly the early years of an undertaking).

The statutory word "activity" is bound to cause much controversy in the administration of the law. This word is not defined in the Bill; in fact, it would be difficult to define. An activity can embrace an entire trade or business, it can be a functional part of a business, or it can be a segment of a taxpayer's financial activities. For example, a taxpayer operating a manufacturing enterprise may have several plants, warehouses and sales outlets. Is each an activity? Where a taxpayer operates two businesses such as a drug store and an automobile agency, may each be an activity? Is the purchasing arm of a retail establishment an activity? Where a taxpayer operates a crop farm in conjunction wtih a livestock farm, is each an activity or must both be combined as one activity? Where individual taxpayers enter into financial transactions such as investments in securities, acquiring interests in real estate, etc., are each of these "an actvity" for the purposes of the proposed legislation?

In order to avoid unnecessary uncertainty and confusion and to deal in an equitable manner with what is probably intended, we suggest that the term "trade or business" be substituted for "activity." This term already has an established meaning under present law and under numerous court decisions. It embraces a set of activities that make up a "whole concept" as distinguished from dealing with possibly meaningless fragments of operations which could cause difficulties in tax accounting, allocations and administration.

It seems from the wording of the proposed amendment that it would apply to all taxpayers. We have seen no suggestion in the Reports of the Committee on Ways and Means nor do we know of any abuses by corporations, trusts, estates and other taxpayers in the area for which correction is sought. Accordingly, it is urged that this proposed amendment be limited to individual taxpayers.

SECTION 221 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTIONS 163 AND 1202

Limitation on deduction of interest

Present law.—Under present law, individual taxpayers are allowed an itemized deduction, without limitation, for all interest paid or accrued during the taxable year.

Proposed change.—The bill would limit the deduction allowed individuals and other noncorporate taxpayers for interest on funds borrowed for investment purposes. The limitation would not apply to interest incurred on funds borrowed for other purposes, such as home mortgages, installment purchases, consumer goods, personal or student loans, or in connection with a trade or business.

Under the limitation, the taxpayer's deduction for investment interest would be limited to the amount of his net investment income, plus an amount equal to the amount by which his net long-term capital gain exceeds his net short-term capital loss, plus $25,000 ($12,500 in the case of a separate return by a married individual).

Interest for which a deduction was disallowed in a year as a result of the limitation could be carried over to subsequent years and used to offset net investment income (including capital gains) arising in the later years to the extent allowable under the limitation in such a year.

In the case of partnerships, the limitation would apply at both the partnership and the partner levels.

AICPA comments.—We do not agree with this proposed amendment of the Code. It has long been an established general principle of economics, accounting and taxation that expenses incident to the production of income are deductible from such income. This legislative proposal in a sense represents an artificial and arbitrary mutation of this principle which would tend to discourage the assumption of risk and the investment of capital—both of which have been important factors in the growth and development of our economic system. Furthermore, it would constitute an inconsistent exception to the cash receipts and disbursements method of accounting under which expenses are deducted when they are paid and income is taxed when it is received.

If, however, this proposed amendment of the Code is enacted in basically its present form, it is suggested that the limitation be made applicable at both the corporate and the shareholder level in the case of electing small business corporations as defined in Code section 1371(b).

SECTION 231 OF THE BILL—PROPOSED CODE SECTION 82 AND PROPOSED AMENDMENT TO CODE SECTION 217

Moving expenses

Present law.—A deduction from gross income is allowed for certain moving expenses related to job-relocation or moving to a first job.

Two conditions must be satisfied for a deduction to be available. First the taxpayer's new principal place of work must be located at least 20 miles farther from his former residence than his former principal place of work (or, if the taxpayer had no former place of work, then at least 20 miles from his former residence). Second, the taxpayer must be employed full time during at least 39 weeks of the 52 weeks immediately following his arrival at the new principal place of work.

Job-related moves often entail considerable expense in addition to the direct costs of moving the taxpayer, his family and his personal effects to the new job location.

Moreover, the 20-mile test allows a taxpayer a moving expense deduction even where the move may merely be from one suburb of a locality to another, and the 39-week test denies the deduction where a taxpayer is prevented from satisfying the test by circumstances beyond his control.

Proposed change.—The bill extends the present moving expense deduction to also cover three additional types of job-related moving expenses:

1. Travel, meals and lodging expenses for premove house-hunting trips;
2. Expenses for meals and lodging in the general location of the new job location for any period of up to 30 consecutive days after obtaining employment; and
3. Various reasonable expenses incident to the sale of a residence or the settlement of a lease at the old job location, or to the purchase of a residence or the acquisition of a lease at the new job location.

A limitation of $2,500 is placed on the deduction allowed for these three additional categories of moving expenses. In addition, expenses for the house-hunting trips and temporary living expenses may not account for more than $1,000 of the $2,500.

The bill also increases the 20-mile test to a 50-mile test, and provides that the 39-week test is to be waived if the taxpayer is unable to satisfy it due to circumstances beyond his control. Finally, the bill requires that reimbursements for moving expenses must be included in gross income.

AICPA comments—General.—The bill provides a maximum deduction of $2,500 for three additional types of job-related expenses: (1) travel, meals and lodging expenses in connection with house-hunting trips; (2) expenses for meals and lodging in the new job location area for any period of up to 30 consecutive days after obtaining the new job; and (3) expenses concerning the sale of a residence or settlement of a lease at the old job location or comparable expenses at the new job location. The deduction for the first two types of expenses may not exceed $1,000 of the maximum $2,500.

We do not believe these amounts are realistic. Many persons transferred own a house which has a market value of $30,000 or more. The average real estate agent's fee for the sale of such a house is 6 percent, or $1,800. In such a situation the allowable deduction for the first two types of expenses would be limited to $700. Thus, a taxpayer transferred to an area of 100 miles from his present location would probably not be out-of-pocket; however, a taxpayer transferred 1,000 miles would probably be out-of-pocket because of the additional transportation costs for himself and his family. We recommend that there be no limitation on the amount allowed as a deduction for these three types of expenses or, in the alternative, that the $1,000 be increased to $2,000 and the $2,500 be increased to $5,000.

Code section 217, as amended, refers to a deduction by a taxpayer as an employee. We recommend that this section also authorize such a deduction by a self-employed taxpayer or by a partner of a partnership. There is no reason why such taxpayers should not be entitled to the same benefits as an employee.

The proposal requires as a condition to allowance that the new place of work be 50 miles further from the old residence than the place of former employment. The requirement is excessive. An employee formerly commuting 20 miles to his old employment in some cases could not qualify for the deduction unless the new employment was 70 miles from his former residence. This is not realistic even in our largest metropolitan areas. The 20-mile rule should be retained, although an alternative provision of 20 miles or 50 percent farther, whichever is greater, might provide some restriction on the supposed favored treatment of a person originally commuting a substantial distance.

Section 231(d) of the bill should be changed to make the effective date applicable to taxable years beginning on or after January 1, 1964, and should permit the filing of claims for refund within one year from the date the Bill becomes law for those taxable years for which the three-year statute of limitations has expired. It is patently unfair to taxpayers who have moved in prior years and suffered a cash loss not to permit them to file claims for refund.

SECTION 301 OF THE BILL—PROPOSED CODE SECTION 84

Limit on tax preferences

Present law.—Under present law, there is no limit on how large a part of his income an individual may exclude from tax as a result of the receipt of various kinds of tax-exempt income or special deductions.

Proposed change.—The bill would impose a 50 percent ceiling on the amount of a taxpayer's total income (adjusted gross income plus tax preference items) which can be excluded from tax. This limitation would not be applicable if an individual's total tax preferences for the year did not exceed $10,000, or $5,000 for a married person filing a separate return.

AICPA comments.—The provisions of the bill placing a limit on tax preferences would impose a tax by indirect means on amounts which presently are fully or partially tax exempt. We agree that public confidence in our self-assessment system is undermined by the ability of individuals to realize large amounts of disposable income with little, if any, payment of tax. However, we recommend that the tax preference items be dealt with through direct legislation. If this is not practicable then we would support the provisions of the bill—with one modification. The tax preference item regarding the excess of accelerated depreciation over straight line depreciation should likewise provide for a reduction when straight line depreciation exceeds accelerated depreciation.

SECTION 302 OF THE BILL—PROPOSED CODE SECTION 277

Allocation of deductions

Present law.—Under present law an individual is permitted to charge his personal income tax deductions entirely against his taxable income without charging any part of these deductions to his tax-free income. As a result, taxpayers with substantial tax preference amounts and personal deductions can eliminate much or all of their tax liability on substantial amounts of otherwise taxable income.

Proposed charge.—To prevent individuals with tax preference amounts from reducing their tax liabilities on their taxable incomes by charging all their personal deductions to their taxable incomes, the Bill provides that individuals (and estates and trusts) must allocate most of their itemized personal deductions proportionately between their taxable income (adjusted gross income less non-allocable expenses) and their tax preference amounts. Only the part of these personal deductions which is allocated to taxable income is to be allowed as a tax deduction and the personal deductions allocated to the tax preference amounts to be disallowed. Tax preference amounts are taken into account only to the extent they exceed $10,000 ($5,000 for a married person filing a separate return).

We support this section of the bill.

SECTION 311 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 1301–1305

Income averaging

Present law.—Income averaging permit a taxpayer to mitigate the effect of progressive tax rates on sharp increases in income. His taxable income in excess of 133⅓ percent of his average taxable income for the prior 4 years generally can be averaged and taxed at lower rates than would otherwise apply. Certain types of income such as net long-term capital gains, wagering income, and income from gifts are not eligible for averaging.

The exclusion of certain types of income from income eligible for averaging complicates the tax return and makes it difficult for taxpayers to determine easily whether or not they would benefit from averaging. In addition, taxpayers with fluctuating income from these sources may pay higher taxes than taxpayers with constant income from the same sources or fluctuating income from different sources. Finally, the 133⅓ percent requirement denies the benefit of averaging to taxpayers with a substantial increase in income and reduces the benefits of averaging for those who are eligible.

Proposed change.—The bill extends income averaging to net long-term capital gains, income from wagering and income from gifts. It also lowers the percentage by which an individual's income must increase for averaging to be available from 133⅓ percent to 20 percent.

AICPA comments.—We support this provision of the Bill but take exception to the proposed effective date of taxable years beginning after December 31, 1969. We note that the provisions of the Bill dealing with the repeal of the alternative tax on capital gains for individuals (Bill section 511) are to be effective with respect to sales and dispositions occurring after July 25, 1969. The effective dates of these two provisions coupled with the 10 percent tax surcharge now in effect subjects long-term capital gain realized by individuals in the brief period from July 26 to December 31 to a severe and inequitable tax penalty. We believe equity dictates that the effective dates for eliminating the alternative capital gains tax and introducing the new averaging provisions be the same.

(NOTE.—Please refer to our comments in the summary regarding the effective dates of capital gains and losses.)

SECTION 321 OF THE BILL—PROPOSED CODE SECTION 85 AND PROPOSED AMENDMENTS TO CODE SECTIONS 402(b) AND 403

Present law.—Restricted property: At present the treatment of restricted property is governed by Treasury regulations which provide for no tax when the employee receives the restricted stock. When the restrictions lapse, the value of the stock at the time of transfer to the employee (determined without restrictions) is treated as compensation provided it has increased in value. If the value decreases then the lower value is considered the compensation.

Proposed change.—Section 321 of the bill provides that a person who receives a beneficial interest in property by reason of services performed is to be taxed with respect to the property at the time it is received if he can transfer the property and if it is not subject to substantial risk of forfeiture. If there is a substantial risk of forfeiture a tax is imposed when the risk lapses. The tax will be on the amount by which the fair market value of the property exceeds the amount the employee paid for it.

AICPA comments.—We support this provision on condition that any legislation finally approved continues to provide for the 50 percent maximum rate on earned taxable income. This provision, coupled with the capital gain provisions in the Bill, reflects a recognition of equality of tax treatment between earned income and capital gain income. We believe that these provisions, taken together will continue to provide incentive for those who have contributed much to our economic progress and will also lessen the search for transactions motivated by tax avoidance.

SECTIONS 341 AND 342 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 665–669 AND 677

Accumulation trusts, multiple trusts, etc.

Present law.—If a grantor creates a trust under which the trustee is either required or is given discretion to accumulate the income for the benefit of designated beneficiaries, then to the extent the income is accumulated, it is taxed at indiivdual rates to the trust.

When the trust distributes accumulated income to the beneficiaries, in some cases they are taxed on the distributions under a so-called throwback rule. The throwback rule treats the income for tax purposes as if it had been received by the beneficiaires in the years in which it was received by the trust. The beneficiary recomputes his tax for these back years, adding the trust income to it and taking credit for the tax which had been paid by the trust on that income, and pays the additional tax due in the current year.

In addition to the limitation of its application to the 5 years preceding the year of distribution, the throwback rule does not apply to several types of distributions.

The progressive tax rate structure for individuals may be avoided when a grantor creates trusts which accumulate income taxed at low rates, and the income in turn is distributed at a future date. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary.

Proposed change.—H.R. 13270 provides that beneficiaries are to be taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiaries currently as earned, instead of being accumulated in the trust. The Bill, in effect, eliminates the 5-year limitation and all exceptions to the throwback rule, and provides an unlimited throwback rule with respect to accumulation distributions. However, only distributions of income accumulated by a trust (other than a foreign trust created by a U.S. person) in years beginning after April 22, 1964 are to be subject to the throwback rule.

In the case of these accumulation trusts, all of their accumulated income, other than income distributable currently, is to be taxed to the beneficiaries upon its distribution to them. The amounts distributed are to be treated as if they had been distributed in the preceding years in which income was accumulated but are includible in income of the beneficiaries for the current year.

The bill also provides that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

AICPA comments.—We agree with these provisions of the Bill in principle. However, it is wholly inconsistent for the equitable administration of the income tax law to provide effective dates for implementation of proposed restrictive changes which are retroactive in effect and impact. Thus, we disagree with the proposal that the changes embodied in Bill section 341 should be reflected for distributions made subsequent to April 23, 1969 based on amounts accumulated since April 23, 1964. Many trusts were set up on the basis of the exception to throwback available in section 665(b) of the Code (prior to the proposed changes). These include so-called minors' trusts which terminate at age 21 and payment of amounts as final distributions by trusts which are made more than nine years after the date of last transfer to such trust. In many cases by the terms of the trust instrument, distributions could not take place prior to April 23, 1969 and in many other situations taxpayers could not be on notice that action had to have taken place prior to the proposed effective date in order to avoid adverse tax impact.

Therefore, it is proposed that the changes set forth in section 341 of the Bill be applicable only to those trusts established or additions made to existing trusts after April 23, 1969 with respect to eliminating the exceptions available under Code section 665(b). Concomitantly, it is suggested and recommended that for those accumulation trusts which cannot qualify under these exceptions, the effective date with respect to full or maximum throwback apply only to accumulations in fiscal years ending after April 23, 1969.

SECTION 401 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 46, 179, 821, 823, 1561–1563 AND PROPOSED CODE SECTION 1564

Multiple corporations

Present law—Under present law, corporations generally are taxed at the rate of 22 percent on the first $25,000 of taxable income and at 48 percent of taxable income in excess of $25,000. The lower tax rate on the first $25,000 of taxable income is commonly referred to as the surtax exemption.

Present law limits to some extent the ability of a taxpayer to split his business enterprise into a number of corporations so as to obtain multiple surtax exemptions by providing that a "controlled group" of corporations is limited to one surtax exemption. Instead of claiming one surtax exemption for the group of corporations, however, a controlled group may elect for each member to take a surtax exemption if each of the corporations pays an additional 6 percent tax on the first $25,000 of its taxable income.

Although the surtax exemption was designed to help small businesses, large organizations have been able to obtain substantial benefits from the exemption by dividing the organization's income among a number of related corporations.

In addition to the surtax exemption, there are other provisions of present law designed to aid small businesses. These other provisions are: (1) the provision which allows a corporation to accumulate $100,000 of earnings without being subject to the penalty tax on earnings unreasonably accumulated to avoid the dividend tax on shareholders; (2) the life insurance company small business deduction of 10 percent of the company's net investment income (this deduction is limited to $25,000 per year); (3) the exception to the general 50 percent limitation on the investment credit which allows 100 percent of tax liability up to $25,000 to be taken into account, and the investment credit provision which allows up to $50,000 of used (as distinct from new) equipment to qualify for the credit; (4) the provision which allows an additional first year depreciation allowance equal to 20 percent of the cost of the property (limited to $10,000 per year); (5) the provision which grants mutual insurance companies (other than life and marine) benefits similar to the surtax exemption; and (6) the provision which exempts mutual companies (other than life or marine) from tax if their investment income does not exceed $150,000.

Proposed change.—H.R. 13270 provides that a controlled group of corporations is only to be allowed one surtax exemption and in addition is not to be allowed to receive multiple benefits under other provisions of the law designed to aid small businesses. Generally, the limitation provided by the Bill is to be phased in over an 8-year period and is to be fully effective for 1976 and later years.

A controlled group of corporations is limited to one $25,000 surtax exemption and one $100,000 accumulated earnings credit after an 8-year transition period. This is accomplished by gradually reducing the amount of the special provisions in excess of one which is presently being claimed by a controlled group over the years 1969 to 1975 until these excess special provisions are reduced to zero for 1976 and later years.

The limitation on multiple benefits from the investment credit and first year additional depreciation, becomes fully effective with taxable years ending on or after December 31, 1969. To ease the transition, controlled corporations are allowed to increase the dividend received deduction from 85 percent to 100 percent at a rate of 2 percent per year.

Under the present consolidated return regulations, preconsolidation losses for a corporation in a group claiming multiple surtax exemptions may be carried over after consolidation only against the income of the corporation which sustained the losses. The Bill modifies these present regulations so as to permit net operating losses for a taxable year ending on or after December 31, 1969, to be taken as a deduction against the income of other members of such group in the same proportion as the additional surtax exemptions of such group.

The bill also broadens the definition of a controlled group of corporations.

We support these proposed amendments to the Code.

SECTION 411 OF THE BILL—PROPOSED CODE SECTION 279

Corporate mergers—Disallowance of interest deduction in certain cases

Present law.—Under present law a corporation is allowed to deduct interest paid by it on its debt but is not allowed a deduction for dividends paid on its stock or equity.

It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Although this problem is a long-standing one in the tax laws, it has become of increasing significance in recent years because of the increased level of corporate merger activities and the increasng use of debt for corporate acqusiton purposes.

There are a number of factors wheih make the use of debt for corporate acquisition purposes desirable, including the fact that the acquiring company may deduct the interest on the debt but cannot deduct dividends on stock.

Proposed change.—In general, the bill disallows a deduction for interest on bonds issued in connection with the acquisition of a corporaton where the bonds have specfied characteristics which make them more closely akin to equity.

The disallowance rule of the bill only applies to bonds or debentures issued by a corporation to acquire stock in another corporation or to acquire at least two-thirds of the total value of the assets of another corporation. Moreover, the disallowance rule only applies to bonds or debentures which have all of the following characteristics; (1) they are subordinated to the corporation's trade creditors; (2) they are convertible into stock; and (3) they are issued by a corporation with a ratio of debt to equity which is greater than two to one or with an annual interest expense on its indebtedness which is not covered at least three times over by its projected earnings.

An exception to the treatment provided by the bill is allowed for up to $5 million a year of interest on obligations which meet the prescribed test.

Ths provision of the bill also does not apply to debt issued in tax-free acquisitions of stock of newly formed or existing subsidiaries, or in connection with acquisitions of foreign corporations if substantially all of the income of the foreign corporation is from foreign sources.

AICPA comments.—We disagree with section 411 of the bill, which would add new section 279 to the Code. It is our view that any restrictions on the "tide of conglomerate mergers" should be imposed outside the tax law. In any event, we feel that the criteria contained in proposed Code sections 279 (b) and (c) are arbitrary and of doubtful validity. Furthermore, the $5 million amount contaned in proposed section 279(a) is discriminatory. Other difficulties will involve tracing problems and the question of what constitutes a "plan" of acquisition. Finally, the section will adversely affect persons who for valid business reasons may desire to sell their businesses in that they may be unable to realize a proper price because of the depressing effect of proposed section 279.

SECTION 412 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 453(b)

Corporate mergers—Limitation on installment sales provision

Present law.—Under present law, a taxpayer may elect the installment method of reporting a gain on a sale of real property, or a casual sale of personal property where the price is in excess of $1,000. The installment method, however, is available only if the payments received by the seller in the year of sale (not counting debt obligations of the purchaser) do not exceed 30 percent of the sales price.

The Internal Revenue Service has not ruled as to whether the installment method of reporting gain is available where the seller receives debentures. The use of the installment method of reporting gain where debentures are received by a seller of property may result in long-term tax deferral. Present law does not specify the number of installments which are required if a transaction is to be eligible for the installment method of reporting. In other words, it is not clear whether the installment method may be used when there is only one or a limited number of payments which may be deferred for a long time.

Proposed change.—The bill places two limitations on the use of the installment method of reporting gain on sales of real property and casual sales of personal property.

First, bonds with interest coupons attached, in registered form, or which are readily tradable, in effect are to be considered payments in the year of sale for purposes of the rule which denies the installment method where more than 30 percent of the sales price is received in that year.

The second limitation is contained in proposed Code section 453(b)(3). It would deny the use of the installment method unless the payment of the loan principal, or the payment of the loan principal and the interest together, are spread relatively evenly over the installment period. This requirement would be satisfied if either payments are made at least once every two years in relatively even or declining amounts over the installment period, or at least 5 percent of the loan principal is to be paid by the end of the first quarter of the installment period, 15 percent is to be paid by the end of the second quarter, and 40 percent is to be paid by the end of the third quarter.

AICPA comments.—We disagree with section 412 of the Bill to the extent that it would add proposed section 453(b)(3) to the Code. It is our concern that proposed section 453(b)(3) will disqualify from installment sale treatment transactions which presently have good business purpose. It would add more uncertainties to an already difficult area. Furthermore, problems presented by extension, calls or other modifications are not provided for. It is our view that proposed section 453(b)(4), with which we concur, is adequate to cover present abuses of the installment method.

SECTION 413 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 1232

Corporate merger—Original issue discount

Present law.—Under present law, original issue discount arises when a corporation issues a bond for a price less than its face amount. The owner of the bond is not taxed on the original issue discount until the bond is redeemed or until he sells it, whichever occurs earlier.

The corporation issuing the bond, on the other hand, is allowed to deduct the original issue discount over the life of the bond.

This results in a nonparallel treatment of original issue discount between the issuing corporation and the bondholder. The corporation deducts a part of the discount each year. On the other hand, the bondholder is not required to report any of the discount as income until he disposes of the bond.

Proposed change.—The bill generally provides that the bondholder and the issuing corporation are to be treated consistently with respect to original issue discount. Thus, the Bill generally requires a bondholder to include the original issue discount in income ratably over the life of the bond. This rule applies to the original bondholder as well as to subsequent bondholders.

Corporations issuing bonds in registered form should be required to furnish the bondholder and the Government with an annual information return regarding the amount of original issue discount to be included in income for the year.

AICPA comments.—We do not agree with section 413 of the bill. We feel that the proposed changes violate the well-established rules of the cash method of accounting and further that they will add to complexity and information reporting difficulties far out of proportion to the problem which section 413 is designed to solve.

We should like to recommend an alternative solution to the problem. We suggest that Code section 1221 be amended to exclude from the definition of a capital asset all corporate nonconvertible debt (sometimes referred to as "straight" debt). Such a provision would make all gains and losses on sales of nonconvertilbe corporate debt ordinary income or ordinary deductions, respectively. Nonconvertible corporate debt is acquired by an investor for the principal purpose of realizing a yield on the money invested. It appears that the market value of nonconvertible corporate debt obligations fluctuates in large measure with reference to prevailing interest yields. Accordingly, it seems reasonable to tax as ordinary income or allow as ordinary deductions gains or losses on disposition of the obligations which are primarily mere adjustments of yields.

We are cognizant of the fact that changes in market value of nonconvertible corporate debt can also be attributable to a change in the credit rating of the issuer, and it is true that it might be appropriate to reflect his element as capital gain or loss. However, we feel on balance that the treatment of nonconvertible corporate debt as a noncapital asset will eliminate or reduce the importance of many complexities, including those resulting from Code sections 171 and 1232.

SECTION 414 OF THE BILL—PROPOSED CODE SECTION 249

Corporate mergers—Convertible indebtedness repurchase premiums

Present law.—Under present law, there is a question as to whether a corporation which repurchases its convertible indebtedness at a premium may deduct the entire difference between the stated redemption price at maturity and the actual repurchase price. The Internal Revenue Service takes the position that the deduction is limited to an amount which represents a true interest expense (i.e., the cost of borrowing) and does not include the amount of the premium attributable to the conversion feature. This part of the repurchase is viewed by the Internal Revenue Service as a capital transaction analogous to a corporation's repurchase of its own stock for which no deduction is allowable. There are however, two court cases which hold to the contrary in that they allowed the deduction of the entire premium. Other court cases have been filed by taxpayers to test the validity of the Service's position on this matter.

Proposed change.—In order to clarify the treatment of premiums paid on the repurchase by a corporation of its indebtedness which is convertible into its own stock (or the stock of a controlling or controlled corporation), the Bill provides that the amount of the premium which may be deducted is to be limited to an amount not in excess of a normal call premium for nonconvertible corporate indebtedness. The amount of the premium paid by the corporation upon the repurchase is to be the excess of the amount paid over the issue price of the indebtedness (plus any amount of discount previously deducted and minus any amount of premium previously reported as income).

It is further provided by the bill that a larger deduction may be allowed with respect to the premium where the corporation can demonstrate to the satisfaction of the Secretary or his delegate that the amount of the premium in excess of that otherwise allowed as a deduction is related to the cost of borrowing and is no attributable to the conversion feature of the indebtedness. This exception is designed to allow for changes in the interest rates and to permit market and credit conditions to be taken into account.

We support this proposed amendment to the Code.

SECTION 421 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 301 AND 305

Tax treatmnt of stock dividends

Present laws.—In its simplest form, a stock dividend is commonly thought of as a mere readjustment of the stockholder's interest, and not as income. For example, if a corporation with only common stock outstanding issues more common stock as a dividend, no basic change is made in the position of the corporation and it stockholders. No corporate assets are paid out, and the distribution merely gives each stockholder more pieces of paper to represent the same interest in the corporation.

On the other hand, stock dividends may also be used in a way that alters the interests of the stockholders. For example, if a corporation with only common stock outstanding declares a dividend payable, at the election of each stockholder, either in additional common stock or in cash, the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. His interest in the corporation is increased relative to the interests of stockholders who took dividends in cash. Under present law, the recipient of a stock dividend under these conditions is taxed as if he had received cash.

Sometimes, by means of such devices as convertible securities with changing conversion ratios, or systematic redemptions, the effect of an election to receive cash or stock can be achieved without any actual distribution of stock dividends and therefore without any current tax to the stockholders whose interests in the corporation are increased.

Proposed change.—The bill provides that a stock dividend is to be taxable if one group of shareholders receives a distribution in cash and there is an increase in the proportionate interest of other shareholders in the corporation. In addition, the distribution of convertible preferred stock is to be taxable unless it does not result in such a disproportionate distribution.

The Bill also deals with the related problem of stock dividends on preferred stock. Since preferred stock characteristically pays specified cash dividends, all stock dividends on preferred stock (except antidilution distributions on convertible preferred stock) are a substitute for cash dividends, and all stock distributions on preferred stock (except for antidilution purposes) are taxable under the bill.

We support this section of the bill.

SECTION 501 (b) OF THE BILL—PROPOSED CODE SECTION 636

Natural resources—Mineral production payments

Present law.—A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when that production occurs. Depending on how a production payment is created, it may be classified as a carved-out production payment, or retained production payment which may then be used in a so-called "ABC" transaction.

The use of carved-out production payments can be used to circumvent the limitations on the depletion deduction and the foreign tax credit and to distort the benefits that the net operating loss provisions were designed to provide. In addition, in ABC transactions, taxpayers are able to pay off what is essentially a purchase money mortgage with before-tax dollars rather than after-tax dollars.

Proposed change.—The bill provides in general that carved-out payments and retained payments (including ABC transactions) are to be treated as a loan by the owner of the production payment to the owner of the mineral property.

In the case of a carved-out production payment, the bill provides the payment is to be treated as a mortgage loan on the mineral property (rather than as an economic interest in the property).

This treatment is not to apply to a production payment carved out for exploration or development of a mineral property if, under existing law, gross income is not realized by the person creating the production payment.

In the case of retained production payments (that is, the sale of mineral property subject to a production payment), the Bill provides that the production payment is to be treated as a purchase money mortgage loan (rather than as an economic interest in the mineral property).

AICPA comments.—We recommend that an exception be made to the treatment provided for in section 501(b) of the Bill for production payments used to equalize the investment of participants in a unitization. Producing properties are often unitized in the interest of conservation of natural resources and more efficient production. Some of the owners in a unit may have done more to develop production than others. In order to recognize the greater investments of those who have already done more development work than their share in the unit, adjustments have to be made when the unit is organized. Sometimes these adjustments take the form of cash payments which generally produce an immediate tax impact to the recipient. Therefore, often those parties who have expended more than their share of the costs of development are permitted to retain a larger share of production from the properties until they have recouped their excess investment. This has the effect of spreading the adjustment over the period of time during which the funds are realized from production and also will tend to allow greater percentage depletion to the owner of the more highly developed properties and correspondingly less to the owner of the less developed properties. The revenue is not hurt since the income is bound to be reported by one of the participants or the other. Inasmuch as the unitization of mineral properties ought to be encouraged because it leads to more efficient and less expensive production, an exception for production payments used in connection with poolings and unitizations of mineral properties to adjust the pro rata investments of participants seems justified.

SECTION 501 (C) OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 615 AND 617

Natural resources—Mining and exploration expenditures

Present law.—Present law allows a taxpayer to elect to deduct, without dollar limitation, mining exploration expenditures (that is, exploration expenditures for any ore or mineral other than oil or gas) which are made prior to the development stage of the mine. The availability of this deduction is limited to mines located in the United States or on the outer continental shelf. When a mine reaches the producing stage, the exploration expenditures previously deducted are recaptured, generally by disallowing the depletion deduction with respect to the mine.

A taxpayer who does not elect this unlimited mining exploration expenditure deduction is allowed a limited deduction for exploration expenditures (whether on domestic or foreign mines) without the recapture rules applying. The total deduction under this limited provision for all years may not exceed $400,000.

The allowance of a current deduction for exploration expenditures without applying the recapture rules in the case of expenditures for which the limited deduction is available provides more generous treatment than in the case of most mineral producers which are under the unlimited deduction provision.

Proposed change.—The bill provides that the general recapture rules of present law are to apply to mining exploration expenditures which are deducted under the limited provision of present law. Thus, a deduction will continue to be allowed for foreign or oceanographic explorations under the limited provision, but the general recapture rules will apply with respect to these expenditures.

AICPA comments.—Section 501(c)(1) of the Bill would amend Code section 615 to provide that all expenditures after July 22, 1969, to which section 615 applies would be subject to the recapture provisions of Code section 617. Expenditures made prior to July 23, 1969, are included in determining the $400,000 limitation under section 615. Section 501(c)(2) of the Bill would amend Code section 617 to permit in the case of foreign and oceanographic explorations deductions to the extent the expenditures do not exceed $400,000, reduced by the total of expenditures previously deducted under Code sections 615 and 617.

We support the approach of the bill. However, present Code section 615(f) provides that a taxpayer who has elected either section 615 or section 617 and has not revoked the election cannot elect to apply the other section. The present bill if enacted may cause inequities to taxpayers who made an election under either Code section 615 or section 617 whereas if they had known of the proposed amendments, they might have elected otherwise. Although the time within which to revoke the elections under section 615 or section 617 has not yet expired (see section 615(e)), provision should be made in the proposed amendments to protect those taxpayers who have made elections. The amendments should permit new elections to be made, and provide that this right does not expire until after the final regulations with respect to the bill section 501(c) amendments have been published in the Federal Register (last day of the third month following publication, for example). The reason for such a lengthy period of time to make the new election rests on the fact that the new election should be made only after the taxpayer is fully informed of the position the Internal Revenue Service may take in the final regulations.

SECTION 512 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 1211 AND 1212

Capital losses of individuals

Present law.—Under present law, both individual and corporate taxpayers may deduct capital losses to the extent of their capital gains. In addition, if an individual's capital losses exceed his capital gains, he may deduct up to $1,000 of the excess loss against his ordinary income. Any remaining loss may be carried forward for an unlimited number of years and deducted against ordinary income provided it is not offset by capital gains. On the other hand, where an individual has a net long-term capital gain rather than a net capital loss, a maximum of only one-half of the net long-term capital gain is subject to tax.

If a husband and wife each have capital transactions and a joint return is filed, their respective gains and losses are treated as though they had been realized by only one taxpayer and are offset against each other. On the other hand, when both spouses have capital losses and file separate returns, each spouse is allowed to deduct up to $1,000 of net capital losses from ordinary income. Thus, by filing separately, a married couple may receive a total capital doss deduction against ordinary income of $2,000.

The present treatment of long-term capital losses is inconsistent in the case of individuals with the treatment of their long-term capital gains. Although a maximum of fifty cents of each dollar of long-term capital gains is subject to ordinary tax, when capital losses exceed capital gains, the excess loss is deductible dollar-for-dollar against ordinary income (up to a maximum of $1,000).

In addition, when it is more advantageous to them, married couples can file separate returns, be treated as two separate taxpayers, and each be allowed to deduct up to $1,000 of capital losses from ordinary income. This treatment is permitted even though married couples are generally treated as one taxpayer.

This treatment of losses tends to provide an advantage for people living in community property states because all gains and losses from community property are attributable in equal amounts to each of the spouses by operation of community property law and, therefore, they are automatically eligible for the benefit of the double deduction. On the other hand, spouses living in noncommunity property states must have separate losses in order to claim this advantage—hence, they must either sell assets held in their joint names or each must sell his own assets.

Proposed change.—The bill provides that only 50 percent of an individual's long-term capital losses may be offset against his ordinary income. (Short-term capital losses, however, would continue to be fully deductible.) In addition, the deduction of capital losses against ordinary income for married persons filing separate returns is limited by the House Bill to $500 for each spouse.

We support this section of the bill.

SECTION 513 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 1221

Capital gains and losses—Letters, memorandums, etc.

Present law.—Under present law, copyrights and literary, musical or artistic compositions (or similar property) are not treated as capital assets if they are held by the person whose personal efforts created the property (or by a person who acquired the property as a gift from the person who created it). Thus, any gain arising from the sale of such a book, artistic work or similar property is treated as ordinary income, rather than as a capital gain. Collections of papers and letters prepared and collected by an individual (including papers prepared for the individual), however, are treated as capital assets. Therefore, a gain from the sale of papers of this nature is treated as a capital gain, rather than as ordinary income.

The rationale underlying the treatment provided in present law for copyrights, artistic works and similar property in the hands of the person who created them (or in the possession of a person who received the property as a gift from the person who created it) is that the person is, in effect, engaged in the business of creating and selling the artistic work or similar property.

The collections of papers and letters are essentially simliar to a literary or artistic composition which is created by the personal effort of the taxpayer and should be classified for the purposes of the tax law in the same manner.

Proposed change.—The bill provides that letters, memorandums and similar property (or collections thereof) are not to be treated as capital assets if they are held by a taxpayer whose personal efforts created the property or for whom the property was prepared or produced (or by a person who received the property as a gift from such a taxpayer). For this purpose, letters and memorandums addressed to an individual are considered as prepared for him. Gains from the sale of these letters and memorandums, accordingly, are to be taxed as ordinary income, rather than as capital gains.

We support this section of the bill.

SECTION 514 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 1222

Holding period of capital assets

Present law.—Capital gains on assets held longer than six months are considered long-term gains.

Proposed change.—The bill provides that a long-term capital gain is to be a gain from the sale or exchange of a capital asset held for more than 12 months.

AICPA comments.—Admittedly, the proposed 12 month holding period is arbitrary. We do feel however, that it is desirable to lengthen the six month period. We believe that a holding period beyond six months would more accurately indicate the intention to invest and thereby serve more closely Congressional intent that special tax treatment be afforded gains from investment as distinguished from speculative gains.

SECTION 515 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 402, 403 AND 72

Capital gains and losses—Total distribution from qualified pension, etc., plans

Present law.—An employer who establishes a qualified employee pension, profit-sharing, stock-bonus or annuity plan is allowed to deduct contributions to the trust, or if annuities are purchased, the employer may deduct the premiums.

The employer contributions to, and the earnings of, a tax-exempt trust generally are not taxed to the employee until the amount credited to his account are distributed or "made available" to him. Retirement benefits generally are taxed as ordinary income under the annuity rules when the amounts are distributed, to the extent they exceed the amounts contributed by the employee. Thus, employee contributions to a pension, etc. fund are not taxed when received since these amounts were contributed from after-tax dollars of the employee.

An exception to the general rule of ordinary income treatment of pension benefits, however, provides that if an employee (except a self-employed person) receives his total accrued benefits in a distribution within one taxable year on account of separation from service or death, the distribution is taxed as a capital gain, rather than as ordinary income.

If part or all of this total distribution consists of employer securities, the employee is not taxed on the net unrealized appreciation in the securities at the time of distribution but instead only when the stock is subsequently sold by the employee. The employee is taxed only on the portion of the employer securities attributable to the employer's cost at the time of the contribution to the trust. Furthermore, this portion is taxed at the long-term capital gain rate, rather than at ordinary income rates.

The capital gain treatment of lump-sum pension distributions was originally enacted in the Revenue Act of 1942 as a solution to the so-called bunched-income problem of receiving an amount in 1 taxable year which had accrued over several years.

The capital gain treatment afforded lump-sum distributions from qualified pension plans usually allows employees to receive deferred compensation at a more favorable tax rate than other compensation received for services rendered.

Proposed change.—The bill limits the extent to which capital gain treatment will be allowed for lump-sum distributions from qualified employees' trusts made within 1 taxable year. Capital gain treatment is to be limited to the amount of the total distribution in excess of employer contributions.

The bill also provides for a special 5-year "forward" averaging of the amounts to be treated as ordinary income. The taxpayer computes the increase in tax as a result of including 20 percent of the ordinary income amount of the distribution in his gross income for the taxable year in which the total distribution is made, and then multiplies the increase in tax by 5 to obtain his tax liability on the ordinary income portion. The bill further provides that the taxpayer may recompute his tax on the ordinary income portion at the end of 5 years by adding 20 percent of the amount in the gross income in each of the 5 taxable years, and if this method results in a lower tax than previously paid, he is entitled to a refund.

We support this section of the bill.

SECTION 516(b) OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 1231

Capital gains and losses—Certain casualty losses under section 1231

Present law.—Generally, under present law if the gains on the disposition of certain types of property exceed the losses on this same type of property, in effect, the excess is treated as long-term capital gain. On the other hand, if the losses exceed the gains, then the net loss is treated as an ordinary loss. The types of property subject to this provision generally are depreciable property and real estate used in a trade or business and capital assets which are involuntarily converted.

An exception to this general provision is provided for uninsured losses resulting from casualty or theft in the case of property used in a trade or business (or capital assets held for the production of income). These uninsured losses are deductible in full against ordinary income rather than being required to be netted with other gains and losses under Code section 1231.

The exception to the general section 1231 rule has led to anomalous results. A business taxpayer with a casualty loss on two similar business properties, one of which is insured and one of which is not, is allowed to deduct the uninsured loss in full against ordinary income and at the same time is allowed to treat the gain on the insured property (the excess of the amount of insurance received over his adjusted basis in the property) as a capital gain. In other words, the gain and loss do not have to be netted under section 1231. On the other hand, the netting is required where the business taxpayer only partially (perhaps 5 percent) insures a business property.

Another problem that has arisen under section 1231 is whether it is applicable to casualty losses on uninsured personal assets.

Proposed change.—Casualty (or theft) losses on depreciable property and real estate used in a trade or business and on capital assets held for the production of income are to be consolidated with casualty (or theft) gains on this type of property. If the casualty losses exceed the casualty gains, the net loss, in effect, will be treated as an ordinary loss (without regard to section 1231). On the other hand, if the casualty gains exceed the casualty losses, then the net gain will be treated as a section 1231 gain which must then be consolidated with other gains and losses under section 1231. This rule is to apply where the casualty property is uninsured, partially insured or totally insured.

The bill also clarifies the fact that uninsured casualty losses on personal assets are subject to the basic section 1231 provisions.

We support this proposed amendment to the Code.

SECTION 516(c) OF THE BILL—PROPOSED CODE SECTION 1252

Capital gains and losses—Transfers of franchises

Present law.—The substantial growth of franchising throughout the United States in recent years has raised two significant problems: first, whether transfers of franchises are sales or licenses or, more particularly, whether the retention of powers, rights or a continuing interest in the franchise agreement is significant enough to preclude a sale; and, second, whether franchisors are selling franchises in the ordinary course of business.

The first problem is not dealt with specifically under present law, and must be resolved under general tax principles. Although section 1221 of the Code deals with property held for sale to customers, it does not appear that its relation to franchises has been fully explored by the courts.

Since present law does not specifically deal with these matters, and since there appears to be considerable diversity of opinion among the courts as to whether the transfer of a franchise constitutes a license or a sale and whether part or all of sale of a franchise constitutes the sale of a capital asset, the bill attempts to clarify these problems.

Proposed change.—The bill adds a new section to the Code providing that the transfer of a franchise is not to be treated as a sale or exchange of a capital asset or of property to which section 1231 applies, if the transferor retains any significant power, right or continuing interest with respect to the subject matter of the franchise.

The general rule is not to apply with respect to amounts received or accrued, in connection with a transfer of a franchise, which are attributable to the transfer of all substantial rights to a patent, trademark or trade name (or the transfer of an undivided interest therein which includes part of all such rights), to the extent the amounts are separately indentified and are reasonable in amount. These amounts, as is the case with the transfer of a patent under Code section 1235, would be entitled to capital gains treatment.

We support this proposed amendment to the Code.

Capital gains and losses—Effective date

General comment.—The effective date for the capital gain and loss provisions of the Bill is generally July 25, 1969. This date can impose serious tax penalties for those sales or dispositions which are made after July 25, 1969 pursuant to action taken prior to that date. We therefore suggest that the effective date be established at December 31, 1969, or, in the alternative, eliminate from the provisions of the Bill any transactions to which the seller was committed in writing on or before July 25, 1969. Further, we suggest that insofar as the repeal of the alternative capital gains tax for individuals and the character of the gain is concerned, collections or other dispositions in connection with transactions in which the installment method was elected should be treated as if they occurred on or before July 25, 1969.

SECTION 521 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 167 AND 1250

Real estate depreciation

Present law.—Under present law, the first owner may take depreciation allowances for real property under the double declining balance method or the sum of the years digits-method. These rapid depreciation methods generally permit large portions of an asset's total basis to be deducted in the early years of the asset's useful life. A subsequent owner is permitted to use the 150 percent declining balance method which also provides more rapid depreciation than straight line in the early years.

Depreciation is allowed on the total cost basis of the property (minus a reasonable salvage value), even though the property was acquired with little equity and a large mortgage.

Net gains on sales of real property used in a trade or business are, with certain exceptions, taxed as capital gains and losses are treated as ordinary losses. Gain on the sale of buildings is taxed as ordinary income to the extent of depreciation taken on that property after December 31, 1963, if the property has been held more than 12 months. If the property has been held over 12 months, only the excess over straight-line depreciation is "recaptured". That amount is reduced after 20 months, at the rate of 1 percent per month, until 120 months, after which nothing is recaptured.

The present tax treatment of real estate has been used by some individuals as a tax shelter to escape payment of tax on substantial portions of their economic income. The rapid depreciation methods now allowed make it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property.

Proposed change.—Under the Bill the most accelerated methods of real estate depreciation (the 200 percent declining balance and the some of the years digits-methods) are limited to new residential housing. To qualify for such accelerated depreciation at least 80 percent of the income from the building must be derived from rentals of residential units. Other new real estate, including commercial and industrial buildings, is to be limited to the 150 percent declining balance depreciation method. In general the new rules will not apply to property if its construction began before July 25, 1969, or if there was a written binding contract to construct the building before July 25, 1969.

Only straight line depreciation is to be allowed for used buildings acquired after July 25, 1969. A special 5-year amortization deduction is provided under certain conditions in the case of expenditures after July 24, 1969, however, for the rehabilitation of buildings for low-cost rental housing.

Finally, the Bill provides for the recapture of the excess of accelerated depreciation over straight line depreciation on the disposition after July 24, 1969, of depreciable real property (but only to the extent of depreciation taken after that date). Thus, to the extent of this excess depreciation, the gain on the sale of the real property will be treated as ordinary income rather than as capital gain.

We support this section of the bill.

SECTION 541 OF THE BILL—PROPOSED CODE SECTION 1379

Subchapter S corporations

Present law.—Subchapter S of the Code was enacted in 1958 to provide tax relief for small business corporations. These provisions do not deal with employee retirement plans; consequently, Subchapter S coporations may estbalish corporate retirement plans for the benefit of shareholders who are also employees of the corporation.

Prior to 1962, self-employed persons (proprietors and partners) were not able to establish such plans to benefit themselves. In 1962, however, Congress enacted the Self-Employed Individuals Retirement Act (H.R. 10), permitting self-employed persons to be treated as employees of the businesses they conduct so that they may be covered under qualified employees retirement plans in much the same manner as their employees. These provisions, though, contain certain specific requirements as to proprietors and partners which limit contributions to 10 percent of the proprietor's or partner's earned income, or $2,500, whichever is less.

The H.R. 10 limitations on retirement income plans described above do not apply to corporations.

Proposed change.—The bill provides limitations, similar to those contained in H.R. 10, with respect to contributions made by Subchapter S corporations to the retirement plans for those individuals who are "shareholder-employees," defined as employees or officers who own more than 5 percent of the corporation's stock. Under the Bill, a shareholder-employee must include in his income the contributions made by the corporation under a qualified plan on his behalf to the extent contributions exceed 10 percent of his salary or $2,500, whichever is less.

AICPA comments.—We strongly support the objective of achieving similarity of tax treatment as between shareholders of electing corporations and partners. If parallel treatment of retirement plans is required to attain this goal, it would be acceptable. However, we believe that the rules governing self-employed retirement plans presently are overly restrictive and that a change to align the treatment of electing corporations with them would be a move in the wrong direction. Rather, we urge that the rules governing self-employment retirement plans be amended to make them more nearly comparable to those covering corporate executives.

In the event the principle of the Bill is accepted in its present form by your Committee, we believe that modification in the treatment of forfeitures should be included.

A separation will have to be made between forfeitures applicable to contributions made, while an electing small business corporation, in years beginning prior to January 1, 1970 and those forfeitures applicable to contributions made on or after that date. This imposes an adminisrative burden on the trustees but it is one that is necessary to prevent a shareholder-employee from receiving a greater contribution than allowable under proposed Code section 1379(b). An alternative plan which we suggest and which could reduce this burden would be to allow forfeitures to be credited to the shareholder-employee with any excess of the aggregate share of forfeitures applicable to contributions for years beginning after December 31, 1969 plus the share of contributions for such years over the lesser of (A) 10% of compensation or (B) $2,500 limitation being included in gross income by the shareholder-employee.

In connection with forfeitures, the Bill simply refers to forfeitures attributable to contributions, with no mention made of the earnings (or loss) applicable to such contributions. We believe that the term forfeitures should apply to contributions adjusted for earnings (or losses) since the dates of such contributions.

Proposed section 1379(c) prohibits carryovers of unused contributions from Subchapter S years to nonsubchapter S years. Code section 404(a)(3)(A) should be amended to conform.

SECTION 801 OF THE BILL—PROPOSED AMENDMENT TO CODE SECTION 141

Increased in standard deduction

Present law.—Under present law, a taxpayer may deduct his personal exemptions and also either his itemized deductions or the standard deduction in order to determine his taxable income. The standard deduction is the larger of the 10-percent standard deduction (10 percent of adjusted gross income) or the minimum standard deduction, but in neither case may it exceed $1,000 ($500 in the case of a married individual filing a separate return).

The 10 percent standard deduction was introduced in 1944 to reduce the complexity of the income tax for the vast majority of taxpayers. Instead of keeping records of deductible personal expenditures and itemizing deductions on their tax returns, more than 82 percent of taxpayers were able to use the simpler standard deduction when it was first introduced.

The combined effect of increased personal expenses and rising incomes has reduced the proportion of taxpayers using the standard deduction from over 82 percent in 1944 to an estimated 58 percent in 1969.

Proposed change.—It is desirable to simplify the preparation and auditing of individual income tax returns by increasing the number of taxpayers using the standard deduction. For this reason and to provide tax reduction to middle-income taxpayers the bill increases the standard deduction to 15 percent with a $2,000 ceiling in three stages.

The bill provides that the standard deduction will be 13 percent with a $1,400 ceiling in 1970, 14 percent with a $1,700 ceiling in 1971 and 15 percent with a $2,000 ceiling in 1972.

We support this proposed amendment to the Code.

SECTION 801 OF THE BILL—PROPOSED AMENDMENTS TO CODE SECTIONS 3 AND 141

Low income allowance

Present law.—The minimum standard deduction was enacted by Congress in 1964 to relieve from income tax persons with low incomes. While the action taken in 1964 providing for the minimum standard deduction provided some relief for low-income individuals, it still left some 5.2 million returns at or below the recognized "poverty level" who are still paying income taxes.

Proposed change.—The bill supplements what in the past has been called the "minimum standard deduction" to raise the minimum amount of exempt income for a family unit to $1,100, plus the number of $600 exemptions available to the family unit.

Under the bill for 1970, the new "low income allowance" consists of an amount called the "basic allowance" (formerly known as the minimum standard deduction) and the "additional allowance" (the new feature added by this bill). The basic allowance (as is true of the minimum standard deduction under present law) generally amounts to $200, plus $100 for each personal exemption allowed to the taxpayer up to a total of $1,000.

Thus, in the case of a single person entitled to one exemption the amount added to the $300 basic allowance is $800; in the case of a family unit of two members, the amount added to the $400 available under the basic allowance, is $700. As the amount of the basic allowance increases (by $100 for each exemption), the additional allowance added by this bill (in order to maintain a uniform $1,100 of tax-free income per family unit) decreases (by $100).

In 1970 only, the bill provides a phase-out of the low income allowance, to the extent it exceeds the present minimum standard deduction. This excess is to be reduced by $1 for each $2 that the taxpayer's gross income exceeds the nontaxable income level. The phase-out is repealed after calendar year 1970.

We support this proposed amendment to the Code.

SECTION 802 OF THE BILL—PROPOSED CODE SECTION 1348

Maximum tax on earned income

Present law.—Under present law, the individual income tax rates reach a maximum of 70 percent for taxable income in excess of $100,000 for single persons and $200,000 for joint returns. The 70 percent rate is applicable to all taxable income other than capital gains subject to the alternative rate of 25 percent.

The high rates are, in part, responsible for attempts to shelter income from tax and for the diversion of considerable time, talent and effort into "tax planning" rather than economically productive activities.

Proposed change.—The bill provides that the maximum marginal tax rate applicable to an individual's earned income is not to exceed 50 percent. This is, in effect, an alternative tax computation for earned income under which earned taxable income in the taxable income brackets where the tax rate would otherwise be greater than 50 percent is subject to a flat 50 percent rate.

We support this section of the bill.

RECOMMENDATIONS FOR AMENDMENTS TO THE INTERNAL REVENUE CODE

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DETERMINATION OF TAXABLE INCOME

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Determination of Taxable Income

SECTION 61(a)(1)

1. Compensation for Services

Such items as commissions earned by an insurance agent on policies on his own life and real estate commissions received by a salesman on a purchase of real estate for his own account represent a reduction in cost and should not be treated as compensation for services rendered.

In *Sol Minzer* v. *Commissioner*, 279 F. 2d 338, it was held that a broker's commission on policies on his own life was income to him and in *Kenneth W. Daehler* v. *Commissioner*, 281 F. 2d 823, it was held that the commission received by a salesman on real estate purchased for his own account was compensation for services.

No economic income can be derived from services rendered to one's self and, therefore, no taxable income should arise.

SECTION 162

2. Deduction for Expenses in Securing Employment

Individual taxpayers should be allowed to deduct expenses under Section 162 which are directly related to securing specific employment, whether or not employment is actually obtained.

There are two aspects of this problem: first, the deductibility of the expenses of securing specific employment and, second, the section under which the expenses should be deductible.

The deductibility question received considerable attention when Revenue Ruling 60–158 (1960–1 CB 140), holding fees paid to employment agencies by employees nondeductible, was published and subsequently revoked by Revenue Ruling 60–223 (1960–1 CB 57). The latter ruling states that IRS "will continue to allow deductions for fees paid to employment agencies for securing employment" but does not mention other expenses in connection with securing employment. The same compelling reasons for the change in the Service's stand with regard to employment agency fees justifies the deductibility of other similar expenses.

When a search for employment is unsuccessful, the expenses should also be made specifically deductible. (See *Francois Louis*, TC Memo, 1966-204, which holds that employment agency fees incurred in an unsuccessful employment search were not deductible.) The economic status of an unemployed taxpayer is usually at a low point. It is equitable that expenses incurred in seeking employment at such a time be deductible.

Expenses incurred in connection with the search for employment are within the concept of business expenses of Section 162 and should be so treated. In Revenue Ruling 55-600 (1955-2 CB 576) the IRS expressed this concept by saying, "Salaries and fees received by a taxpayer as compensation for services rendered represent income from a trade or business. . . ." This ruling followed the Tax Court's decision in *Joe B. Luton*, 18 TC 1153.

SECTION 162(a)(2)

3. *Application of "Overnight Rule" For Business Expenses*

A deduction should be allowed for meal expenses on business trips whether or not the taxpayer is away from home overnight.

Section 162 permits a deduction for business expenses while away from home on business trips. The Internal Revenue Service has consistently disallowed such expenses unless the taxpayer is away from home overnight except where business needs require that rest be obtained during released time.

Until 1967, the courts did not support the Internal Revenue Service, stating, in effect, that the word "overnight" does not appear in the Code and, therefore, has no application. However, in 1967 the Supreme Court of the United States (in *U.S.* v. *Correll* et ux., 389 U.S. 299) held that daily trips not requiring rest or sleep are "not away from home." Thus, business expenses incurred during such trips are not deductible. This decision disregards the basic economic fact that an abnormal expense is incurred in many such situations.

Legislation should be enacted to make it clear that the taxpayer is required neither to be away from home overnight nor to rest or sleep to claim this deduction.

SECTION 165(g)(3)(A)

4. *Worthless Securities in Affiliated Corporation*

An ordinary deduction should be permitted with respect to worthless securities in any corporation in which the degree of ownership required for consolidated returns exists.

Present law provides a deduction for worthless securities in an affiliated corporation in which at least 95 percent of each class of stock is owned directly by the taxpayer corporation.

This provision dates back to a provision enacted in 1942. In Report No. 1631 (77th Congress, 2nd Session) the Senate Committee on Finance stated that this provision would permit such losses to be taken in full as an ordinary deduction by the parent corporation if it owned directly 95 percent of each class of stock of the subsidiary. The Report further states that: "Such a parent and subsidiary corporation may file consolidated returns and to this extent the corporate entity is ignored. Thus, the losses of the one may be offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent corporation to take in full the losses attributable to the complete worthlessness of the investment in the subsidiary." At that time the law required the ownership of 95 percent of stock for the filing of a consolidated return.

The Internal Revenue Code of 1954 reduced the percentage of ownership required for the filing of a consolidated return to 80 percent.

To be consistent with the premise on which the worthless security provision was originally enacted, Section 165(g)(3)(A) should be amended to reduce the required percentage of ownership of stock from 95 percent to 80 percent, and the percentage ownership requirement should relate only to stock other than preferred stock which is nonvoting and limited as to dividends.

7. Amortization of Intangible Assets

The cost of purchased goodwill, trademarks, trade names, secret processes, formulae, licenses, and other similar intangible assets should be amortizable over a stated period fixed by statute to the extent that such items are not otherwise deductible under other sections of the Internal Revenue Code.

When cerain intangible assets are developed the costs:

1. May be deducted as paid or incurred, or at the election of the taxpayer, amortized over a period of not less than 60 months if the expenditures are research and experimental expenditures (Section 174).

2. May be amortized over a period of not less than 60 months if the expenditures are in connection with a trademark or trade name (Section 177).

It is inequitable to treat the costs of intangible assets purchased by a taxpayer differently from those incurred in the development of intangible assets. A taxpayer who purchases certain intangible assets can amortize their costs if a definitely determinable life can be established for them or, failing that, upon proof of abandonment of the asset.

For various reasons it may be difficult or impossible to demonstrate with reasonable certainty either a definitely determinable life or abandonment. The difficulty is complicated further where the value of intangible assets is subject to erosion from various causes, such as changes in technology, obsolescence, changes in public buying habits, deterioration of business conditions in geographic areas, or other shifts in social and business habits. Many court decisions and IRS rulings have held that no amortization is allowable in these circumstances because the total useful life of the intangible asset cannot be estimated, even though its value obviously was impaired.

The House Ways and Means Committee Report (Report No. 1337, 83rd Congress, 2nd Session) which accompanied H.R. 8300 stated that one of the reasons for the enactment of Section 174 was to "eliminate uncertainty and to encourage taxpayers to carry on research and experimentation." Equally important reasons exist for encouraging the mobility of capital by providing that taxpayers who purchase intangible assets (which resulted, in most instances, from expenditures by the seller which were deductible under Section 174 or 177) should be permitted to amortize those costs over a reasonable period of time.

The Code should be amended to provide that the cost of all purchased intangible assets such as those listed above should be amortizable:

1. Over the actual life of the intangible asset if a definite life can be determined; or

2. If a definite life cannot be determined, over a period of 120 months or, at the election of the taxpayer, a longer period.

Section 1245 should provide, if it does not now do so, for recapture of amortization claimed when the intangible assets are sold or otherwise disposed of in a transaction covered by Section 1245.

SECTION 166(f)

5. Bad Debt Deduction for Guarantor of Corporate Obligations and for Lenders of Business Loans

Section 166(f) should be amended to provide uniformity of treatment in the deduction of a bad debt regardless of whether the borrower is incorporated or unincorporated or whether the unincorporated taxpayer is a direct lender or guarantor.

The payment by a noncorporate guarantor, endorser or indemnitor of a noncorporate debt in discharge of his obligation qualifies as an ordinary deduction if the proceeds of the loan were used in the trade or business of the borrower. In *Max Putnam* v. *U.S.*, 352 U.S. 82, the Supreme Court held that a payment by an individual in discharge of his obligation as guarantor of a corporate debt constituted a nonbusiness bad debt deductible only a short-term capital loss. Furthermore, a noncorporate lender, not in the business of lending money, who lends directly to a corporate or noncorporate borrower when the funds are used in the borrower's trade or business is limited to short-term capital loss treatment for bad debts arising from such loans.

Small business development should be fostered by allowing ordinary deductions to unincorporated taxpayers regardless of whether the loss is sustained as a direct lender, guarantor, endorser or indemnitor and regardless of whether the borrower is corporate or noncorporate. This treatment would not be allowed where a corporate borrower exceeded specified limits as to equity capital (similar to the provisions of Section 1244(c) (2)).

SECTION 167

6. Depreciation of Leasehold Improvements

Leasehold improvements should be considered depreciable property even though the estimated economic life of the property is longer than the term of the lease.

Under the provisions of Section 167, taxpayers are permitted various accelerated methods of depreciation providing the asset is property used in the trade or business of the taxpayer or property held for the production of income. On the other hand, amortization deductions under Section 162 are only allowable in equal annual amounts over the life of the least.

Regulations Section 1.167(a)-4 indicates that capital expenditures for improvements on leased property are recoverable through allowances for either depreciation or amortization. If the useful life of the improvements is equal to or shorter than the remaining period of the least, the allowances take the form of depreciation under Section 167. Where the useful life of the improvements is longer than the term of the lease, Regulations Section 1.162-11(b) (1) provides that an annual amortization deduction is allowed which is equal to the total cost of the improvements divided by the number of years remaining in the term of the lease.

The Supreme Court has held in *Hertz Corporation*, 364 U.S. 122, and *Massey Motors, Inc.*, 364 U.S. 92, that for purposes of depreciation "useful life" is the period over which the assets may reasonably be expected to be useful to the taxpayer in *his* trade or business, and not the period of the economic life of the assets. If a taxpayer has made improvements on leased property where the term of the lease is shorter than the economic life of the improvements, the useful life to that taxpayer is the term of the lease. This taxpayer should therefore be entitled to an accelerated depreciation deduction and not be restricted to straight-line amortization. In determining the term of the lease, Section 178 would, of course, be applicable.

SECTIONS 167, 611, 642

8. Depreciation and Depletion—Estates

Allocation of the dedutcion for depreciation and depletion should be made according to distributable net income only where alloction is not provided by the will.

In the case of an estate, the allowable deductions for depreciation and depletion are apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate allocable to each, regardless of any provisions to the contrary in the will. This requirement does no seem reasonable and should be amended so it will apply only where no allocation is provided by the will. Moreover, the suggested change would conform the rules for estates to those applicable to trusts.

SECTION 172(b)

9. Eight-Year Carryover of Initial Losses

A minimum carryback-carryover period of eight years in the case of new corporations should be allowed.

It frequently happens that new corporations, particularly small businesses, undergo a substantial period of operating losses at the beginning of their existence, and may find that the inability to carry back such losses, coupled with the five-year carryover limitation, causes an insufficient period to permit taxable income to reach a level where initial losses can be fully absorbed.

In order to provide relief to new corporations it is recommended that a combined carryback and carryover period of eight years be provided. Thus a loss sustained in the first year should be eligible as a carryover for eight years following the loss year; a loss sustained in the second year should be eligible for a one-year carryback and a seven-year carryover and so forth. This would provide equality of treatment with existing corporations in that an eight-year period would be available to all.

SECTION 172(d)(4)(D)

10. H.R. 10 Plan Contributions: Self-Employed Individuals

Section 172(d)(4)(D) provides that a deduction otherwise allowable for contributions to an H.R. 10 plan for the benefit of self-employed individuals and owner-employees is not to be treated as being applicable to the trade or business of the individual for purposes of computing a net operating loss. This is an unwarranted restriction on the deductibility of such a contribution and should be eliminated.

Section 172 establishes the rules for computing the amount of operating loss, operating loss deduction, and operating loss carryback or carryover. Operating loss is defined as the excess of the deductions allowed by Chapter 1, with certain exceptions, over the gross income. One exception for an individual is that expenses which are not attributable to the taxpayer's trade or business are allowed only to the extent that the taxpayer has gross income not derived from such trade or business.

The statute now provides (Section 172(d)(4)(D)) that contributions to an H.R. 10 plan on behalf of self-employed individuals and owner-employees are deemed not to be attributable to a trade or business for purposes of computing a net operating loss.

Assume the situation of a taxpayer who conducted a business having an H.R. 10 plan which operated at a profit in 1968 after a contribution to the H.R. 10 plan and who had a casualty loss substantially in excess of the profit from the business. If the taxpayer had no nonbusiness income, it would be necessary to reduce the net operating loss for 1968 by the contribution to the H.R. 10 plan for the benefit of the owner-employee in determining the amount to be carried back to prior years.

In such a case the contribution to the H.R. 10 plan is an expense of the taxpayer's trade or business and should be so treated for the purposes of determining the net operating loss deduction. Otherwise, the effect is the disallowance of a portion of the casualty loss.

Section 172(d)(4)(D) should be repealed so that an H.R. 10 plan contribution is treated as a business deduction in determining a net operating loss.

SECTION 177

11. Deduction for Trademark and Trade Name Expenditures

Trademark and trade name expenditures should be allowable as amortizable deductions free of any election.

Section 177 provides that at the election of the taxpayer any trademark or trade name expenditure may be treated as a deferred expense and amortized over a period of not less than 60 months. If this election is not made the item is capitalized.

Section 177 and the regulations thereunder require that the items to which the election to defer and amortize applies must be specifically itemized and identified in an election filed with the return. This requirement creates problems because the election may be overlooked where items are not identified in the accounts to indicate that they are subject to deferral and amortization. For example, defense of a trademark may be carried on by the taxpayer's regular counsel and the related legal expense may not be indicated in the invoices from the attorney. Thus the election to amortize the trademark defense costs may not be made.

The election requirement of Section 177(a) constitutes an unnecessary complication of the Code. The deductibility of an item should be determined by the nature of the item rather than by strict compliance with the requirements of an election. Trademark and trade name expenditures should be deductible over a period of not less than 60 months free of any election.

SECTION 212

12. Deduction for Preliminary Investigation of Business or Investment Opportunities

Expenses paid or incurred by an individual during a taxable year with respect to expenditures incurred in search of a prospective business or investment should be deductible regardless of whether the proposed transaction was consummated.

Prior to 1957 the Internal Revenue Service followed I.T. 1505 I-2 (CB 112) in permitting a deduction for expenses incurred in determining whether or not an investment should be made. The ruling held that such an investigation constituted a transaction entered into for profit and that upon abandonment of the enterprise the expenses incurred became a loss deductible in the year of abandonment.

I.T. 1505 was based upon Section 214(a)(5) of the Revenue Act of 1921 and the related regulations. This section of the 1921 Act corresponds to Section 165 (c)(2) of the Internal Revenue Code of 1954, which allows a deduction by individuals for "losses incurred in any transaction entered into for profit, though not connection with a trade or business. . . ."

Revenue Ruling 57-418 (1957-2 CB 143) revoked I.T. 1505 after reviewing the history of the application of the rule and established a new rule that "a loss sustained during a taxable year with respect to expenditures incurred in search of a prospective business or investment is deductible only where the transaction has actually been entered into and the taxpayer abandons the project."

Expenditures made in connection with a preliminary investigation of business or investment opportunities should be deductible even if a taxpayer abandons the prospective project before entering into a material amount of activity in connection with it. Such preliminary expenditures should be equivalent to those which are admittedly deductible where the taxpayer *has* engaged in material activity. See *Charles T. Parker*, 1 TC 709, distinguished by the IRS in Revenue Ruling 57-418.

There appears to be no equitable justification for limiting the deduction of investigatory expenses to situations where the prospective business or investment was actually entered into and subsequently abandoned. If a taxpayer makes a good faith investigation of a business prospect which is clearly identifiable and incurs expenditures reasonable and necessary thereto, then ordinary standards of equity and fairness should permit deduction of those expenses. The requirement of material activity in the business before deduction of those expenses is permitted places an arbitrary and unbusinesslike burden on individuals interested in development of new economic opportunities.

SECTION 217

13. Moving Expenses

The definition of moving expenses should be expanded to cover additional out-of-pocket expenses directly related to employee relocations and relocations of the businesses of self-employed persons.

The deduction for moving expenses enacted in the Revenue Act of 1964 should be expanded to improve labor mobility, to relieve the substantial economic burden on employee-taxpayers who relocate and to promote business growth and opportunity.

Specific statutory recognition should be given to additional out-of-pocket costs directly related to employee relocations, including necessary expenditures during a reasonable period of search for housing at the new location and out-of-pocket costs of acquisition and disposition of ownership, leasehold or other interests in residential property. Costs of this nature may present a more serious financial problem to the individual being moved than the transportation expenses of the move. All such reasonable costs and expenses should be deductible.

It should be made clear that any expanded definition of moving expenses applies also to "old" employees who may be reimbursed by their employers.

With respect to reimbursement, the Code should be amended to eliminate the current burdensome requirement that employers withhold tax on such payments when there is reason to believe the employee cannot deduct the costs as moving expenses.

To facilitate business growth and opportunity, a similar deduction should also be allowed to self-employed persons for expenses incident to the moving of their businesses from one location to another.

SECTION 245(b)

14. Certain Dividends Received From Wholly-Owned Foreign Subsidiaries

The 100 percent dividend-received deduction should be liberalized by reducing the required percentage of ownership by the domestic corporation from 100 percent to 80 percent and permitting this deduction to U.S. corporations whose foreign subsidiaries have less than all of their gross income effectively connected with a U.S. trade or business.

Section 245(a) provides that, if a foreign corporation is engaged in trade or business in the United States for a 36-month period, and if 50 percent or more of its gross income for such period is effectively connected with the U.S. trade or business, a corporate recipient of dividends paid by the foreign corporation is entitled to the 85 percent dividend-received deduction to the extent the dividend is paid out of earnings and profits attributable to gross income effectively connected with the foreign corporation's U.S. business.

Section 245(b) provides that, in lieu of the 85 percent deduction of Section 245(a), a 100 percent deduction will be allowed if (1) the foreign corporation is a 100 percent-owned subsidiary and (2) *all* of its gross income for the year out of the earnings and profits of which the dividend is paid was effectively connected with a U.S. trade or business. The 100 percent deduction is only available if a Section 1562 election for the parent was not effective either in the year the earnings arose or in the year the dividend is received.

Section 245(b) is generally comparable to Section 243(b), which allows a 100 percent dividend-received deduction for certain domestic intercorporate dividends. However, Section 243(b) requires only the 80 percent ownership needed for affiliated group status to qualify the dividend for the special deduction, rather than the 100 percent required in Secton 245(b).

Further, the requirement that *all* gross income of the foreign corporation be effectively connected with a U.S. business seems extremely harsh. The benefits of the 100 percent dividend-received deduction could be lost entirely in situations where as little as $1 of the gross income of the foreign corporation is not effectively connected with a U.S. business.

It does not appear that there is any logical reason why the rules of Section 245(b) should be more restrictive than those of Section 245(a) as long as conditions comparable to those of Section 243(b) are met. Accordingly, Section 245(b) should be amended to permit a 100 percent deduction in an appropriate case as long as there is 80 percent ownership by the domestic corporation and at least 50 percent of the gross income of the foreign corporation for a 36-month period is effectively connected with a U.S. trade or business. The amount of this deduction would be computed on the same basis as is now provided for the deduction under Section 245(a).

The result of these changes would be that, if the domestic parent could have made a Section 243(b) election with respect to a foreign corporation's dividends if the foreign corporation had been a domestic corporation, it would be permitted the same tax treatment as if such an election had been made, but only to the extent that the dividends are paid out of earnings and profits already subjected to full U.S. tax. In cases where a Section 243(b) election would not be permissible if the subsidiary were domestic, either because of less than 80 percent ownership or the existence of a Section 1562 election, the 85 percent deduction would continue to apply.

SECTION 246(b)

15. Limitations on Deductions for Dividends Received

The limitation on the amount of the dividends-received deduction to 85 percent of taxable income should be amended to allow a deduction of 85 percent on all dividends received from domestic corporations.

Section 243(a)(1) allows a deduction to a corporation of an amount equal to 85 percent of the dividends that it receives from domestic corporations, but Section 246(b)(1) limits the 85 percent deduction to 85 percent of taxable income. Section 246(b)(2) provides that the limitation in Section 246(b)(1) does not apply for any taxable year for which there is a net operating loss. The limitations imposed on the dividends-received deduction by Sections 246(b)(1) and (2) cause needless complexity and sometimes provide an illogical result when the existence of an insignificant amount of net operating income causes a substantial curtailment in the dividends-received deduction which would not have occurred if a net operating loss (no matter how small) had existed.

The Revenue Act of 1964 amended the Code to allow a 100 percent deduction in the case of qualifying dividends received (from related companies), and the 2 percent tax applicable to consolidated income tax returns was repealed. These amendments should facilitate the free flow of funds between related corporations. Elimination of the limitation on the 85 percent dividends-received deductions provided in Sections 246(b)(1) and (2) would improve the situation further.

SECTION 248

16. Deductions for Organizational and Reorganizational Expenditures

Organizational expenditures should be allowable as amortizable deductions free of any election and such deductions should be expanded to cover stock issuance and reorganization expenses (including stock dividends and stock splits), registration and stock listing costs.

Section 248(a) provides that organizational expenses may, at the election of the taxpayer, be amortized over a period of not less than 60 months to be selected by the taxpayer. The regulations require that this election be made in the return for the taxable year in which the taxpayer begins business and that all of the expenditures subject to the election be specifically identified.

The election requirement of Section 248(a) constitutes an unnecessary complication of the Code. The deductability of an item should be determined by the nature of the item rather than upon strict compliance with the requirements of an election. Organizational expenses and expenses of a like or similar nature should be deductible over a period of not less than 60 months free of any election.

In addition, the deduction under Section 248 should be expanded to cover stock issuance and reorganization expenses, including the costs of stock registration and stock listing and the costs of printing certificates whether for original issue, stock dividends, or stock splits. There should be no statutory distinction between creating the legal corporate entity and its reorganization or recapitalization, however accomplished, nor in obtaining the capital with which to carry out the corporate purposes initially or subsequently.

SECTION 265(2)

17. Interest Relating To Tax-Exempt Income

Dealers in municipal bonds should be permitted to make an annual election to include municipal bond interest in gross income and be allowed a deduction for all their interest expense or, in the alternative, be denied a deduction for interest expense only to the extent of their income from municipal bond interest.

Under present law the Internal Revenue Service uses certain formulas to disallow interest expense. In the case of municipal bond dealers, an excess of interest expense over interest income may be necessary to make a profit on the sale of securities—which profit is taxed at ordinary income tax rates. If Section 265(2) is amended as suggested herein, municipal bond dealers, like other taxpayers, would then be taxed on their true business profits.

SECTION 269

18. Carryover of Operating Losses—Acquisition of New Businesses

It should be made clear that in the absence of a change of ownership of 50 percent or more of an existing corporation, carryover of operating losses should not be denied merely because of the acquisition of new businesses.

For an explanation of this recommendation refer to the explanation of recommendation number 46 on p. 34.

SECTION 269

19. Acquisitions to Evade or Avoid Federal Income Tax

Section 269(a)(1) should include an exception for acquisitions of control of one corporation by another corporation where both corporations were controlled by the same stockholders immediately before the acquisition.

Section 269 provides for the disallowance of deductions, credits or other allowances in the case of certain acquisitions where the principal purpose of the acquisition is the evasion or avoidance of federal income tax. The section covers two types of acquisitions:

1. Acquisition of control of a corporation.
2. Acquisition of property of another corporation, the basis of which is determined by reference to the basis of such property in the hands of the transferor corporation.

In the case of the acquisition of property (2 above), there is an exception where the transferor corporation and transferee corporation were controlled by the same shareholders immediately before the acquisition. The exception insures that deductions, credits or allowances will not be denied due to transfers within a single economic group.

A similar exception should apply in the case of acquisition of control of a corporation. As presently constituted, Subsection 269(a)(1) can operate to deny losses or other deductions sustained within a single economic group. The Congressional Committee Reports under Section 129, Internal Revenue Code of 1939 (predecessor of Section 269), do not indicate that this was intended. To the contrary, the reports cite the abuses of purchasing corporations with current, past or prospective losses for the purpose of reducing income taxes.

Further, rulings published by the Internal Revenue Service have permitted the utilization of tax benefits through statutory mergers (or equivalent thereof) of controlled corporations, since the mergers constituted acquisitions of assets rather than acquisition of control or corporations. See Revenue Ruling 66-214 (1966-2 CB 98) and Revenue Ruling 67-202 (1967-1 CB 73). There is no reason for a distinction.

Accordingly, it is recommended that Subsection 269(a)(1) be amended to provide an exception where a corporation acquires control of another corporation if both corporations were controlled by the same stockholders before the acquisition.

SECTION 274

20. *Deduction of Certain Entertainment, Etc., Expenses*

Entertainment, amusement and recreation expenses which are ordinary and necessary business expenses should be deductible.

Section 274 should be amended to provide for the deductiblity of entertainment, amusement or recreation expenses for both an activity and a facility the extent they are incurred to further the taxpayer's trade or business. The taxpayer would, of course, be required to substantiate such expenses by adequate records or other sufficient evidence.

Corporate Distributions and Adjustments

SECTIONS 301(b)(1)(B), 301(d)(2)(B)

21. *Recognition of Gain to Distributor Corporation*

All gain recognized to a distributor corporation upon the distribution of property to a corporate distributee should be taken into account in determining the amount of the distribution and the basis of the distributed property.

The present statute specifically refers to those sections of the law that provide for recognition of gain to distributor corporations from the distribution of LIFO inventory, properties subject to indebtedness in excess of basis, and gains recognized under Sections 1245 and 1250. It is recommended that the language in Section 301(b)(1)(B) and 301(d)(2)(B) be changed to take into account all gain recognized to a distributor corporation, regardless of the particular sections that might create authority for such recognition, and reference to selected sections should be eliminated. For example, the distribution of installment obligations to a corporate distributee, which creates gain recognized under Section 453(d), should also be included under Sections 301(b)(1)(B) and 301(d)(2)(B).

SECTION 302

22. *Lost Basis—Redemption of Stock Taxed as Dividend*

Basis should not be lost when redemptions of stock are taxed as dividends.

It is recommended that specific statutory provisions be enacted along the following lines:

1. Where the proceeds of stock which is sold or redeemed are taxed as ordinary income, the allocation of basis to other stock held by the taxpayer, if any, should be permitted.
2. If the taxpayer has been taxed on account of direct attribution (through family partnership, estate, corporation, or trust), the basis of his stock should be allocated to the stock that was the basis of the attribution.
3. The taxpayer to whose stock basis is allocable hereunder should be allowed at least one year from the date of final determination (that a redemption is to be treated as a dividend) to file claim for refund if the statute of limitations would otherwise foreclose that right.

4. With respect to Section 302(c)(2)(A), if during the ten-year period in which the reacquisition rules apply, the taxpayer should acquire an interest in the corporation, provision should be made to prevent the loss of the basis of the stock surrendered in the redemption distribution which is subsequently treated as a dividend.

A taxpayer should not lose tax benefit from the basis of shares surrendered in a redemption transaction that is subsequently treated as a dividend. The statute should clearly state what happens to the basis of stock surrendered in such a transaction and should extend the statute of limitations for filing a refund claim if the taxpayer to whom basis is allocated under the statutory rules would otherwise be deprived of tax benefit. If there is a reacquisition during the ten-year period, the statute of limitations is left open for assessment under present law. Similar protection should be extended for the basis of the stock redeemed.

SECTION 302(C)(2)

23. Constructive Ownership of Stock

If a decedent (immediately before his death) could have qualified for a complete termination of shareholder's interest under Section 302(b)(3) then his estate should also qualify.

Section 302(c) permits a distribution in complete termination of a shareholder's interest, as described in Section 302(b)(3), to be treated as a distribution in full payment in exchange for stock even though the terminating shareholder may be related to another shareholder under the attribution rules described in Section 318(a)(1).

However, if that same shareholder were to die prior to terminating his interest, and the stock were later redeemed from the estate, whose beneficiary was not a shareholder but whose beneficiary was related to another shareholder within the meaning of Section 318(a)(1), the Internal Revenue Service would hold that complete termination did not take place. See Revenue Ruling 59–233 (1959–2 CB 106). While that specific ruling involved attribution through a trust, the ruling has been cited by the Internal Revenue Service as applying also to estates.

It is suggested that the exception to the attribution rules contained in Section 302(c)(2) be broadened to include estates as well as family members.

SECTION 303(b)(2)(B)

24. Distributions in Redemption of Stock to Pay Death Taxes

The present provisions of Section 303(b)(2)(B), permitting the benefits of Section 303(a) in situations where the decedent's estate includes stockholdings of two or more corporations, seem unduly restrictive. The percentage of ownership as to the stock of each corporation required in order for the 35–40 percent tests to apply should be calculated using constructive ownership rules.

This section of the Code now provides for aggregating the values of stock in two or more corporations if the estate owns more than 75 percent in value of the outstanding stock of each of such corporations. In *Estate of Otis E. Byrd* v. *Commissioner*, 388 F. 2d 223, it was held that this test applies only to directly owned stock. Thus it is possible for an estate to own beneficially most of the stock of several corporations and yet not qualify for aggregation of the values, simply because some of the stock might be held by other corporations in the same group. It seems equitable that the constructive ownership rules of Section 318 be applied for determining qualification under Section 303(b)(2)(B). These rules now apply to redemptions under Section 302 and there is no logical reason why they should not also be considered in Section 303 redemptions.

SECTION 304

25. Acquisitions by Related Corporations

1. The present statute seems unclear and possibly conflicting in its wording. It is recommended that in a brother-sister acquisition, even though the constructive ownership rules of Section 318 might indirectly create a parent-subsidiary relationship, the transaction should clearly be governed by Section 304(a)(1) rather than Section 304(a)(2).

2. The statute now provides that, in the case of brother-sister redemptions, the stock acquired is treated as a contribution to capital, regardless of whether

the distribution itself is treated as a dividend or as a sale or exchange. It is recommended that the statute be amended to provide contribution to capital treatment only in cases where the distribution is treated as a dividend.

Section 304(a)(1) presently set out rules for acquisitions of stock by related corporations other than subsidiaries. Section 304(a)(2) provides rules for acquisitions by subsidiaries. Under the constructive ownership rules of Section 318, stock of a sister corporation can be attributed indirectly to the brother corporation, or vice versa, thereby creating indirectly a parent-subsidiary relationship. A literal interpretation might then require that this type of acquisition (brother-sister) be construed under the provisions of Section 304(a)(2) rather than 304(a)(1). Since there is some difference in treatment under the sections, the statute should be amended to state clearly that acquisitions in brother-sister situations be governed solely by Section 304(a)(1).

Section 304(a)(1) now provides that stock acquired in an acquisition governed by its terms shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation. Apparently, this rule applies regardless of the tax treatment of the acquisition to the shareholder. The rule should apply only to situations where the distribution is treated as a dividend. Where the acquisition is treated as a sale or exchange, it seems more logical and equitable that the acquiring company's basis be equal to the amount paid by it for the stock.

SECTION 332(c)(2)

26. Satisfaction of Indebtedness of Subsidiary to Parent

The rule now stated in this section regarding the satisfaction of indebtedness of a subsidiary to its parent should be amended to provide nonrecognition of gain or loss to the distributing corporation by virtue of distributions of property and discharge of indebtedness created after adoption of the plan of liquidation.

Present law provides only for nonrecognition of gain or loss as to distributions of property in satisfaction of indebtedness existing on the date of adoption of the plan of liquidation. Occasionally, it may be necessary to create similar indebtedness after a plan of liquidation is adopted but before the liquidation is completed. There appears to be no logical reason why the nonrecognition rule should not also apply to distributions of property in satisfaction of this type of indebtedness.

SECTIONS 333(e)(2), 333(f)(1)

27. Liquidating Distributions Acquired Before December 31, 1953

The cut-off date with respect to the acquisition of stock or securities distributed by a corporation liquidating under Section 333 should be revised.

In determining the amount of realized gain that is to be recognized by a shareholder in a Section 333 liquidation, present law provides that realized gain may be recognized to the extent that the shareholder receives money or stock or securities acquired by the liquidating corporation after December 31, 1953. Originally, this cut-off date was necessary in order to prevent the investment of cash in stock or securities in anticipation of a liquidation under Section 333. The date is now unrealistic. The statute should be changed to fix a cut-off date five years prior to the date on which the corporation adopts its liquidation plan.

During the 1st Session of the 90th Congress, Senator Magnuson introduced S. 614 and Representative Adams introduced H.R. 185 to accomplish the objectives of this recommendation.

SECTION 334

28. Basis of Property Received in Liquidation

Uncertainty exists regarding the term "cash and its equivalent" as used in Regulations Section 1.334-1(c)(4). The phrase should be defined by statute in order to simplify the determination of basis to be allocated to assets received in corporate liquidations.

Because of uncertainty resulting from administrative practice and the regulations under Section 334, Congress should establish statutory meaning for the term "cash and its equivalent" as used in allocating basis to assets received in corporate liquidation. In Revenue Ruling 66-290 (IRB-1966-40, 8), the IRS applied the term to certificates of deposit and savings and loan association accounts, as well as cash deposits. The ruling stated, however, that the term does not include accounts receivable, inventories, marketable securities, and other similar current assets.

The interpretation placed on the term "cash and its equivalent" by the IRS seems unduly restrictive and statutory guidelines for taxpayers are most desirable. The basic concept that should apply is the liquidity of the particular assets involved and whether or not they can be converted to cash in a short period of time. Certainly, marketable securities meet this test and should be included within the meaning of the term. In most cases, trade accounts receivable will be converted into cash in a relatively short period of time and should be similarly treated.

Section 334(b) (2) is automatic rather than elective for subsidiaries that are liquidated within a two-year period, and taxpayers presently have little guidance as to the allocation of basis to assets received in such liquidations.

SECTION 334(C)

29. Basis of Property Received in A One-Month Liquidation

Section 334(c), which applies to the allocation of the adjusted basis of stock to property received in a liquidation under Section 333, should be amended to provide for allocation in the following order:

1. To assets which can be converted into cash in a relatively short period of time in an amount equal to their fair market values;
2. To section 1245 and 1250 assets to the extent such gain is recognized, and
3. The residue, if any, to other assets (including Section 1245 and 1250 assets but not in excess of their fair market values) received according to their respective net fair market values.

The present Section 333 basis rules contained in the regulations provide for the allocation of the adjusted basis of the shareholders' stock to the property received according to the respective net fair market values of the property. Since the shareholders' basis is generally less than the fair market value of the property received, the present basis rules can result in double taxation.

For example, assume a company, with no earnings and profits, has two assets, a trade account receivable and a building, each with a fair market value of $50,000. The sole shareholder, with a $60,000 stock basis, reports no gain upon liquidation under Section 333. The trade receivable and building will each receive a basis of $30,000. Upon collection of the receivable, the $20,000 of proceeds in excesst of basis will be taxed as ordinary income, irrespective of the fact that the company previously reported the receivable as income. Similarly, assume instead of the receivable, the company had appreciated post-1953 stock with a basis of $30,000 and a fair market value on $50,000. In this situation, the shareholder would be subject to a $20,000 gain upon liquidation and a $10,000 gain ($50,000–$40,000) upon the sale of the stock.

The recapture rules of Section 1245 and 1250 can result in double taxation as a resulr of a Section 333 liquidation. The company is required to recognize recapture income on the liquidation. In turn, the taxpayers earnings and profits will be increased and additional recognized gain to the shareholder on liquidation may result.

To alleviate these harsh results, Section 334(c) should be amended to provide that the adjusted stock basis be allocated in the following order:

1. To assets which can be converted into cash in a relatively short period of time in an amount equal to their fair market values;
2. To Sections 1245 and 1250 assets to the extent such gain is recognized in proportion to the respective amounts of recapture gain recognized, and
3. The residue, if any, to other assets (including Sections 1245 and 1250 assets but not in excess of their fair market values) received according to their respective net fair market values.

SECTION 636

30. Effect on Liquidating Corporation of Distribution of Property in Liquidation

Section 336 presently provides that no gain or loss be reognized to corporations upon their liquidation. The section should be amended to conform to the provisions of Sections 47, 1245 and 1250, which do provide for the recognition of gain under certain limited circumstances in corporate liquidation transactions.

Due to the fairly recent enactment of Sections 1245 and 1250, under certain conditions, gain will be recognized to the distributing corporation on distributions of property in partial or complete liquidation. This seems directly contrary to the present language of Section 336. It is recommended that Section 336 be amended so as to set out clearly situations where gain will be recognized. Furthermore, some reference should be made to Section 47, covering the recapture of the investment tax credit with respect to certain distributions of Section 38 property. The basic thrust of this recommendation is directed toward clarifying Section 336 so that in addition to its stating the general rule for axing the disributing corporation on distribution of property in liquidation, it will clearly state the exceptions to that rule.

SECTION 337(a)

31. Gain or Loss on Sales or Exchanges in Certain Types of Liquidations

Section 337(a) should be amended to include involuntary conversions within the definition of "sale or exchange."

This section should be amended to specifically include all involuntary conversions within the definition of sale or exchange. In Revenue Ruling 64–100 (1964–1 CB 130), the Internal Revenue Service held that an involuntary conversion resulting from complete destruction by fire or explosion constituted a sale for purposes of Section 337(a), but it has not yet included condemnation awards. All types of involuntary conversions should be treated as a sale for purposes of Section 337.

Furthermore, in connection with any involuntary conversion, the taxpayer should be given a minimum period of 60 days after occurrence of the event within which to adopt a plan of liquidation and obtain the provisions of Section 337.

SECTION 337(C)(1)(A)

32. Collapsible Corporations—Application of Section 337

The nonrecognition of Section 337 should apply to sales made by an otherwise collapsible corporation if any of the limitations of Section 341(d) would prevent the application of Section 341(a) to all of the shareholders of such corporation.

At the present time the benefits of Section 337 are denied to a *corporation* which falls within the general definition of a collapsible corporation as prescribed by Section 341(b). This is true even though the limitations contained in Section 341(d) may prevent the application of Section 341(a), the operative portion of the section, to any of the *shareholders*. There is no logical reason for prohibiting Section 337 treatment in any case where Section 341 is inoperative. Section 337(c)(1)(A) should be amended to eliminate this defect and, at the same time, to refer to the special provisions of Section 341(e)(4).

SECTION 337(C)(2)

33. Liquidation of Subsidiaries in Section 337 Transactions

Section 337 should be amended to include the liquidation of subsidiaries within the benefits of Section 337, if both subsidiaries and their parent are liquidated within the twelve-month period now provided.

As now worded, Section 337(c)(2)(A) denies the benefits of Section 337 in certain parent-subsidiary situations where the subsidiary is liquidated into the parent during the 12-month period required by Section 337(a)(2) and Sections 332 and 334(b)(1) apply to the liquidation. Under present rules there are available several indirect ways to avoid this result (e.g., liquidate the subsidary prior to having the parent adopt its plan of liquidation). However, to meet this problem directly an amendment to Section 337(c)(2) is necessary.

The amendment should extend nonrecognition treatment under Section 337 to the liquidation of a subsidiary if the subsidiary and its parent are liquidated within the 12-month period beginning on the first date of adoption of a plan of liquidation by the subsidiary or the parent.

SECTION 341(a)

34. Treatment of Short-Term Gain

The literal language of this section makes it applicable only to gain that would otherwise be treated as long-term capital gain were it not for the holding period. It is recommended that gain on sale or exchange of all collapsible corporation stock be treated as gain from the sale or exchange of property not a capital asset, regardless of the holding period.

In the event of the sale of, distribution in partial or complete liquidation of, or related distribution with respect to stock held for six months or less, present language would provide that the gain be considered as capital gain even though the corporation was collapsible. Under these circumstances, capital losses could be applied to offset such gain. This does not appear to be consistent with the intent of the collapsible corporation provisions.

SECTION 341(d)(2)

35. Clarification of Over-70 Percent Test

The extent to which "gain is attributable to the property" for purposes of the over-70 percent limitation test should be clarified.

Realization on sale of Section 341 assets in prior years or in the current year up to the date of sale or redemption or distribution in partial or complete liquidation should not be treated as collapsible asset gain. If the corporation has paid or will pay tax on gain realized on previous sales of collapsible assets, it is inequitable to continue to treat the gain as collapsible asset gain.

SECTION 341(f)

36. Certain Sales of Stock of Consenting Corporations

Section 341 should be amended to protect the shareholder who purchases stock in a corporation which has consented to the treatment provided in Section 341(f) where, subsequent to such purchase, it is determined that the corporation was not in fact a collapsible corporation.

This subsection was enacted in August 1964 to provide some relief in connection with sales of stock of corporations which might, at the time the stock sale occurs, be collapsible corporations. This subsection should be amended to provide that the election will not be effective if the corporation is determined not to have been collapsible at the time the sale of stock occurred which necessitated the election. This would prevent an election made out of a superabundance of caution from trapping an unwary purchaser of the stock who had nothing to do with making the election in the first place.

SECTION 351

37. Securities Received in Exchange

The nonrecognition provisions of Section 351 extend to transfers of property to a corporation solely in exchange for stock or "securities" in such a corporation. The term "securities" should be defined by statute to include a note, bond or other evidence of indebtedness with a maturity of five years or more.

One of the problem areas under Section 351, in view of divergent court decisions, is to determine the meaning of the term "securities." A statutory definition is necessary to provide guidance to taxpayers and eliminate unnecessary conflict. The definition should provide that a note, bond, or other evidence of indebtedness with a maturity of five years or more would qualify as a security under Section 351.

SECTIONS 351, 355, 368(C)

38. Control

Legislation is needed to clarify a conflict existing between the statutory definition of corporate control for purposes of Sections 351, 355 and 368(c) and that contained in Revenue Ruling 59–259.

For purposes of these sections, control is defined (Section 368(c)) as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

Revenue Ruling 59–259 (1959–2 CB 115) interprets the above definition to require ownership of at least 80 percent of the total number of shares of *each* class of outstanding nonvoting stock. The language of the Code should be corrected if this ruling properly reflects Congressional intent.

SECTIONS 351, 357(C)

39. Transfers to Controlled Corporation

Accounts receivable and accounts payable transferred from an unincorporated cash-basis transferor to a controlled corporation should result in income to the transferee upon collection of the receivables and a deduction to the transferee upon payment of the payables.

The Internal Revenue Code provides special rules for carrying over various tax attributes in certain types of tax-free transactions. These have the effect of continuing the status of the items carried over even though a new corporation may own the business. However, incorporation of a partnership or sole proprietorship is not covered specifically, and this can cause questions as to the tax results, particularly where the partnership or proprietorship uses the cash-basis of accounting.

For example, a professional partnership may have accounts receivable for work performed and accounts payable for unpaid expenses. Under the cash basis, taxable incomes does not arise until the receivables are collected, and deductions do not occur until expenses are paid. When the partnership incorporates, a question arises as to whether the receipt of the corporation's stock causes a realization of income from the receivables. Likewise, income might be considered to be realized, under Section 357(c) on the transfer of accounts payable where such liabilities exceed the adjusted basis of the receivables transferred.

Equitable treatment would be to permit the transferee to report the income when the receivables are collected and to obtain a deduction when the accounts payable are paid. It should be provided that the transferor does not realize income on a Section 351 transfer of accounts receivable as described above, and that the transferee corporation takes the receivables with a zero basis and is taxed on the subsequent collection. It should also be provided that (similar to the treatment in Section 381(c)(16)) if payment of a liability would have been deductible by the transferor then payment of the assumed liability by the transferee would also be deductible, and that Section 357(c) does not apply in such a situation

SECTION 356(a)(2)

40. Treatment of "Boot"

Section 356(a)(2) as presently worded should be eliminated and replaced by provisions that would:

1. Treat as a dividend for all purposes of the Code any distribution of "boot" which has the effect of the distribution of a dividend within the principles of Section 301.
2. Treat as a partial liquidation under Section 346 such part of the "boot" received which has that effect, and
3. Treat as a redemption of stock under Section 302 such part of the receipt of "boot" which has that effect, determined by reference only to stockholdings of the shareholders of the acquired corporation immediately prior to the reorganization.

With few exceptions, the courts and the Internal Revenue Service have treated the "boot" provisions of Section 356(a) as requiring that any gain attributable to the "boot" first be treated as a dividend to the receiving shareholder to the extent of accumulated earnings and profits. Only the balance of any gain then results in capital gain. There is no sound reason for the apparent inconsistency between Section 356(a)(2) on one hand and Sections 301, 302 and 346 on the other. It is difficult to justify the different language under Section 356, based upon accumulated earnings and profits, rather than first out of current earnings and profits, as under Section 301. It is equally difficult to justify the requirement that the distribution of "boot" in every reorganization will always result in dividend income unless the distributing corporation has a deficit, without regard to whether or not the shareholder has in substance received a distribution in partial liquidation or a distribution arising from a disproportionate redemption of some of his shares.

SECTION 362(b)

41. Basis to the Acquiring Corporation of Stock Received in a B-Type Reorganization

The determination of basis of the acquired company's stock in a B-type reorganization should be simplified in a manner similar to that in a C-type reorganization.

It is often quite difficult to obtain the basis for the acquired company's stock in a B-type reorganization, particularly where it is widely held. To overcome this problem, the Code should be amended to provide that where in a B-type reorganization 80 percent or more of the stock of the acquired company is acquired during a 12-month period, a substituted basis for the stock acquired should be allowed equal to the excess of the basis of the assets in the hands of the corporation being acquired over its liabilities, just as if there had been a C-type reorganization. This would place the transaction in a similar position to a C-type reorganization and should simplify operation of the statute.

SECTION 367

42. *Foreign Corporations*

The Secretary of the Treasury or his delegate should be given statutory authority to make a determination, after an exchange, that such exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Section 367 provides that in determining the extent to which gain shall be recognized in the case of any of the exchanges described in Sections 332, 351, 354, 355, 356, 361, a foreign corporation shall not be considered as a corporation unless, *before* such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Sections 1491 and 1492, enacted at the same time and for a similar purpose, provide that an excise tax of 27½ percent shall be imposed on transfers of stock or securities to a foreign corporation unless, *before* such transfer, it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Notwithstanding the similarity of purpose and structure of these sections, Section 1494(b) provides that the tax otherwise imposed by Section 1491 may be abated, remitted or refunded if *after* the transfer it has been established to the satisfaction of the Secretary or his delegate that the prescribed tax avoidance purpose did not exist. The legislative history discloses no reason for withholding similar relief from the impact of Section 367, which has been and continues to be a trap for the unwary.

To correct this situation it is suggested that the first sentence of Section 367 be amended as follows:

"In determining the extent to which gain shall be recognized in the case of any of the exchanges described in Section 332, 351, 354, 355, 356 or 361, a foreign corporation shall not be considered a corporation unless it is established that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes."

SECTION 368(a)(1)(B)

43. *B-Type Reorganizations—Exchange of Cash*

In an exchange of stock for stock in a B-type reorganization, the issuance by the transferee of cash to avoid fractional shares, or the assumption by the transferee of reorganization expenses or transfer taxes, should not deny qualification for reorganization treatment.

In Revenue Ruling 66-365 (CB 1966-2 176), the Internal Revenue Service recognized some court decisions (e.g., *Mills et al.* v. *Commissioner*, 331 F. 2d 321 (1964)) and stated that the "solely for voting stock" requirement is met where the acquiring corporation pays cash in lieu of issuing fractional shares and the cash is not a separately bargained-for considertion but merely represents a rounding-off of the fractions. Even as so modified, the rule requiring "solely" voting stock seems too stringent. It should be relaxed to permit limited exchanges of cash or other property for legitimate business purposes and to eliminate doubt as to the qualification of a particular transaction as a reorganization. While some departure from the strict language of the Code has been permitted, a statutory "de minimis" rule should be enacted limiting the amount of cash and other property to perhaps 5 percent of the total consideration.

SECTION 381(a)

44. *Tax Attributes in Intercorporate Transfers*

Inheritance by a successor corporation of the various tax attributes of a predecessor corporation should also apply to intercorporate transfers and to transfers to a subsidiary.

The Code should be amended to provide that inheritance by a successor corporation of the various tax attributes of a predecessor corporation should also apply to intercorporate transfers and to transfers to a subsidiary.

Without this amendment, it may be possible for a corporation to terminate previous adverse elections by transferring all or part of its business to a newly formed corporation which can then make new elections that will be more advantageous in the future.

SECTIONS 382, 269

45. General Comment—Carryover of Operating Losses

The whole structure of the Internal Revenue Code as it relates to the taxation of corporations and stockholders is founded on the proposition that the corporation is a separate taxable person. In this connection the concept of "continuity of interest" has been understood as justifying recognition of the identity of a corporate person despite certain changes in its structure. If continued recognition of this concept is desirable, and it seems that it is, there does not appear to be any justification for denying access to carryover deductions except where changes of *both* ownership and business result in the creation of a new business person.

Where stockholders have pooled their capital in a corporation for the purpose of engaging in business for profit but have sustained losses, it is illogical to assume that the stockholders should not seek to recoup those losses by improving the operations of the losing business or by engaging in another business which might be more profitable. If the latter course is taken, and a new business is acquired, the operating loss carryovers should be available as though the recovery were from improved operations.

In the absence of a change of ownership sufficient to interrupt the continuity of interest, the continuing tax identity of the corporate person should be recognized. To do otherwise would be to place fiscal expediency ahead of reasonable tax policy.

For the same reasons, continuation of the separate corporate person should be recognized, as at present, when there is a change of ownership but no significant change in business activities.

Where there is a significant change of business activities coupled with a significant change in ownership, the law should recognize that the effect is the same as formation of a completely new taxable person and the carryover of loss deductions in such circumstances should be denied.

Revenue Ruling 63–40 (1963–1 CB 46) is a step in the right direction in that it provides that operating loss carryovers will not be denied in instances in which a new business is acquired and there is *little or no* change in stock. The conclusion is too narrow, however, and does not take care of the other existing inconsistencies in the statutory sections dealing with operating loss carryovers.

With certain modifications, but within the present basic structure of Sections 269 and 382, the foregoing objectives can be attained. The following recommendations are suggested to accomplish that result.

SECTION 269

46. Carryover of Operating Losses—Acquisition of New Businesses

It should be made clear that in the absence of a change of ownership of 50 percent or more of an existing corporation, carryover of operating losses should not be denied merely because of the acquisition of new businesses.

Revenue Ruling 63–40 (1963–1 CB 46) indicates that if a new business is acquired or after the period in which losses were incurred, the corporation will not be barred from using prior losses against the profits of a newly acquired business. The ruling also states that if there is more than a minor change in stock ownership of a loss corporation which acquires a new business enterprise, the IRS may continue to contest the deductibility of the carryover of the corporation's prior losses against the income of the new business enterprise.

It should be made clear that carryover of operating losses against the profits of a newly acquired business should not be denied unless there is a change of 50 percent or more in the ownership of the company.

SECTION 382

47. Acquisitions Through Reorganizations—Percentage Reduction Rules

The percentage reductions in Section 382(b) applicable in the case of reorganizations of loss companies should be replaced by rules similar to those applicable to purchases under Section 382(a). That is, where shareholders of the loss company do not retain an interest of 50 percent or more in the continuing company, the operating loss should be denied unless a "continuity of business" test is met. There should also be a provision under which substantially all the assets received from the loss company could be transferred to a subsidiary, if the subsidiary meets the continuity of business test.

There seems to be no basis for distinguishing between a sellout accomplished by means of a taxable transaction and one accomplished by a reorganization even though the selling shareholders retain an interest. In either case the "continuity of business" test should be applied. The alternative of allowing the carryover to remain in a subsidiary is necessary to permit use of the loss against profits from a continuation of the loss corporation's business even though the acquiring corporation has other types of business.

SECTION 382 (A) (1)

48. "Continuity of Business' Test

Where there has been a change in ownership of a loss company, a reasonable but more specific "continuity of business" test should be applied. Expansion of existing lines of products or services, including the acquisition of a business having the same or similar products or services, should be permitted. In addition, the company should be permitted to develop a natural growth of the existing business provided that the new activity is not a major portion of the whole. The loss company should not be prevented from dropping unprofitable lines or from moving its location or changing its personnel in an effort to earn profits against which it may offset the loss carryover.

The purpose of Section 382(a) (1) is to prevent new owners from acquiring a loss company and using its loss against profits from an unrelated business undertaken under the new management. However, it also prevents new owners from discontinuing or radically changing unprofitable lines of business and hampers normal expansion and diversification of products or services. These effects are unreasonable and undesirable and should be corrected.

A company in the electronics business, for instance, which is manufacturing a device for a specific kind of measurement should be permitted to:

1. Discontinue its manufacture when technological changes make some other device better.
2. Add to its list of products devices for any other kinds of measurement, either by the company's own research and development or through the acquisition of an existing business.

SECTION 382 (A) (1)

49. Period Over Which Changes in Stock Ownership are Measured

In making a comparison of stock ownership for purposes of Section 382(a), the earlier date should be "twenty-four months before the end of the taxable year."

Section 382(a) provides a period of time over which a change in ownership is measured. This period should be a uniform period, such as 24 months, and should not be shortened merely because a taxpayer has a short taxable year. Short years may arise from entering into or withdrawing from a consolidated group or from a change in fiscal year, neither of which should result in a reduction in the period of time for testing changes in stock ownership.

SECTION 382 (A) (1)

50. Limitation on Denial of Net Operating Loss Carryover

The denial of carryover loss should be restricted to losses which occurred before the change in stock ownership and the change in business.

Because of the present wording in Section 382(a) (1) (A) (ii), if there were a change in ownership and a change in business at the beginning of a taxable year and the changed business showed a net operating loss in that year, that net operating loss could be denied as a carryover to succeeding years. This result probably was not intended and is inequitable. The denial should be limited to losses which occurred prior to the change in stock ownership.

SECTION 382 (A) (4)

51. Definition of "Purchase"—B-Type Reorganization

The definition of "purchase" for the purpose of determining changes in ownership under Section 382(a) should be expanded to include acquisitions of stock for stock in B-type reorganizations.

At present, control of a loss corporation can be acquired by another corporation issuing its own stock in a reorganization that qualifies under Section 368(a)(1)(B) without becoming subject to the restrictions on use of the loss carryover contained in either Subsections (a) or (b) of Section 382. This should not be permitted, and this type of transaction should be brought within the provisions of Section 382(a).

Deferred Compensation, etc.

SECTION 404(A)(5)

52. Contributions to Nonexempt Employees' Trusts

Taxpayers making contributions to a profit-sharing or pension trust not exempt under Section 401 should be allowed a deduction from net income for such payments in the year the amounts are paid to the employees by the trust even though the rights of the employees were forfeitable when the contributions were made.

An employer is allowed to deduct his contributions to an employees' pension trust or annuity plan as provided in Section 404(a)(5) even if the trust to which the contributions are made has not qualified under Section 401, provided the rights of the employees under the plan are vested when the contribution is made. If the employees' rights are forfeitable, the taxpayer is not allowed a deduction in any taxable year, as provided in the Regulations Section 1.404(a)-12.

This limitation forbidding the deduction in any taxable year is inequitable. Where contributions are made to a profit-sharing or pension trust not qualified under Section 401, and the rights of the employees are forfeitable when the contributions are made, the employer should be allowed a deduction (subject to the limitations of reasonableness outlined in Section 162(a)(1)) in the year the amounts are paid to the employees by the trust.

The employees should be required to report as income only the portion of the distribution which was not previously taxed to the trust, and the employer should be allowed a deduction only for the portion of the distribution which is taxed to the employees. The procedure for the allocation should be defined in the regulations.

SECTION 422(c)(3)(c)

53. Stock Option for More than 5 Percent Shareholder-Employee

Options outstanding to all employees should be taken into account in determining whether an employee owns more than 5 percent of the stock of the employer corporation for purposes of Section 422(c)(3)(C).

Section 422(c)(3)(C) provides that in determining whether or not an employee owns more than 5 percent of the stock of the employer corporation, the stock which he may acquire by exercise of the specific option being granted is treated as owned by him.

If there are other options to other employees outstanding, the stock which may be acquired by them upon exercise of their options apparently is not considered as outstanding for purposes of determining whether or not an employee meets the 5 percent test. There appears to be no reason why such other options should not be taken into account.

Accounting periods and methods

SECTIONS 452, 462

54. Taxation of Unearned Income and Allowance of Deductions for Estimated Expenses

The accounting principles originally recognized in Sections 452 and 462 of the Internal Revenue Code of 1954 should be reenacted. Section 452 related to deferral of income received for performance or delivery of service extending beyond the end of the taxable year in which such income is received. Section 462 allowed a deduction for reasonable additions to reserves for estimated expenses.

Unearned income. One of the basic principles of accounting is that income is validated by the delivery of goods or services accompanied by the receipt of cash or a claim for cash. Clearly, equity dictates that a business should not have to pay tax on money which is received but not yet earned, that is, where such receipt is burdened with an obligation to render service, etc., beyond the taxable year of the receipt. The present provisions of Section 455 dealing with prepaid subscription income and Section 456 dealing with certain prepaid dues income, although not completely adequate, do recognize this important principle.

A statutory provision should apply to receipts which carry a definite liability to furnish goods or services in the future. There should be no requirement as to any particular length of time subsequent to the end of the taxable year in which the liability to perform must be satisfied. If a maximum deferral period is considered necessary it should not be less than five years.

Taxpayers should be permitted the option of electing the deferral treatment as to classes of unearned receipts. This would permit immaterial items to be treated on a nondeferral basis.

It is recognized that an adjustment may be required during a transitional period in order to prevent substantial distortion of income.

Estimated expenses. For taxpayers on the accrual basis, another basic accounting principle concerns the matching of deductions and expenses of a fiscal period with the revenues applicable to such period even when it is necessary to estimate the amount of such deductions and expenses.

At the time Section 462 was repealed (originally enacted in the Internal Revenue Code of 1954), Congress expressed its endorsement of the basic principle of allowing taxpayers deductions for reasonable additions to reserves for estimated expenses, with adequate safeguards to prevent the possible abuses which were feared under Section 462 as originally enacted.

A new provision allowing deductions for estimated expenses should now be enacted, with the following limitations to make the provision workable and to gain additional experience with the problems that might be encountered:

1. The categories of estimated expenses for which reasonable additions to reserves would be deductible should be limited at the outset to liabilities to customers, to employees, and for multiple injury and damage claims. Provision for estimated liabilities to customers would include, for example, liabilities for cash and trade discounts, advertising allowances, allowances for defective merchandise, etc. Liabilities to employees would include, among other things, liabilities for vacation payments, workmen compensation claims, etc. Liabilities for multiple injury and damage claims should be restricted to the potential liability on an estimated basis arising out of events which happened before the close of the taxable year of the taxpayer.

2. Taxpayers should be permitted the option of electing to deduct additions to reserves for estimated expenses on an item-by-item basis. A requirement for an all-inclusive treatment covering every conceivable item of eligible estimated expense would carry the danger of a greater revenue impact and of attempts by taxpayers to claim deductions for items which may ultimately be held to be improper in an effort to protect the validity of their election. An item by item election would permit taxpayers to deduct only those estimated expenses which are substantial in amount and which the taxpayers reasonably feel are contemplated within the scope of deductibility of estimated expenses.

3. In order to prevent any immediate unfavorable effect on tax revenues, a transitional adjustment may be required.

SECTION 453(b)

55. Clarification of the Term "Payment" in Taxable Year of Sale

Payments in the initial period should not include a liability assumed by the purchaser unless it exceeds the basis of the property.

Section 453(b)(2) limits the use of the installment sales method to situations where payments in the year of sale do not exceed 30 percent of the selling price. Regulation Section 1.453-4(c) indicates that in the case of the disposition of real estate a mortgage assumed shall not be included as a payment unless it exceeds the basis of the property. Nothing is mentioned about other liabilities assumed. Disputes have arisen where liabilities are assumed by the purchaser. The Tax Court (See *I. Irwin Jr.*, 45 TC 544; and *Horneff*, 50 TC 63) has maintained a position that liabilities assumed are included as payments if actually paid during the year of sale. This Court has also questioned, in dicta, the provision in the Regulations relating to mortgages assumed. It has stated that the provision refers only to mortgages assumed but not paid in the year of sale. On the other hand, two Courts of Appeal have taken the position that an assumption of any liabilities should not be included as an initial payment unless it exceeds basis (See *I. Irwin Jr.*, (CA5) 390 F. 2d 91, and *Marshall* (CA9) 357 F. 2d 294).

Considering the conflict in the area, the Code should be changed to clarify the point. Since the assumption of debt does not provide funds to pay the tax and there would be administrative problems in determining if and when an assumed liability has been paid, it is suggested that the term "payment" be defined to exclude an assumed obligation unless it exceeds the basis of the property sold.

SECTION 453(C)

56. Elimination of Double Taxation Upon Change From Accrual to Installment Basis

Upon a change from the accrual to the installment basis of reporting taxable income from installment sales by dealers in personal property, installment payments actually received during the year on account of sales made in a taxable year before the year of change should be excluded in computing taxable income for such year of change and for subsequent years.

Under the Internal Revenue Code of 1939 a taxpayer changing from the accrual method to the installment method was not permitted to exclude from gross income for the year of change and subsequent years the gross profit which had been included in income and taxed in an earlier year when the taxpayer was on the accrual basis. The result was that such taxpayer was taxed twice on the same income.

The Committee Reports accompanying the Internal Revenue Code of 1954 state that with the intention of eliminating this double taxation, Congress enacted Section 453(c) of the Internal Revenue Code of 1954. Unfortunately, that section does not go far enough, for it still requires that the gross profit from installment payments received after the change to the installment method be included in gross income in the year of receipt even though it had previously been taxed under the accrual method.

Actually, Section 453(c) does not accomplish its intended purpose. Only limited relief is provided from the double tax penalty. Even if it is assumed that the tax rate and gross income is the same for the earlier year and the year of change, the net income and the final tax in the earlier year would probably have been smaller because the expenses of sale would have been deducted in the earlier year under the accrual method. Thus, the Section 453(c) adjustment will not eliminate all the tax in the second year resulting from the inclusion of the gross profit.

In order to accomplish equity between taxpayers who change from the accrual to the installment method of accounting for installment sales and taxpayers who adopted the installment method originally, and in order to bring about the expressed intent of the Congress, Section 453(c) should be amended to permit a changeover to the installment method without double taxation.

It is recognized that an adjustment will be necessary during a transitional period in order to prevent distortion of income.

SECTION 482

57. Mitigation of Statute of Limitations In Related Taxpayer Cases

Whenever the Secretary of the Treasury exercises his right to reallocate income or deductions between or among two or more taxpayers, either the party whose income is decreased or whose deductions are increased by such reallocation should be permitted to pick up the effect of the adjustment without regard to the statute of limitations, or no reallocation should be made under Section 482.

Section 482 permits the Secretary to reallocate income and deductions among related taxpayers where, in his opinion, action is necessary to reflect properly the income of the respective related taxpayers. Where such allocations are made, correlative adjustments to the income of related taxpayer involved in the allocations are required by Regulations where not otherwise barred by law. Often, an increase in taxable income of one of the parties is determined at a time when the statute of limitations with respect to one of the related taxpayers has already expired. This bars a tax refund for such other party which otherwise would be obtainable. Thus, after having collected the tax from one taxpayer, the Secretary can refuse a refund of tax to the other taxpayer affected. In this situation the same income is taxed twice.

The party whose income is decreased or whose deductions are increased by a reallocation under Section 482 should be accorded the right of a correlative adjustment without regard to the statute of limitations. Alternatively, the Section 482 adjustment should not be permitted if the correlative adjustment is barred by the statute of limitations.

Personal Holding Company

SECTION 543(A)(6)

58. Use of Corporate Property by Shareholder

Section 543(a)(6) should be repealed so that all rent income is treated in a consistent manner under Section 543(a)(2). Until enactment of the 1964 amendments, the section prevented the incorporation of private property to protect investment income from personal holding company penalty. The present rent section prevents any appreciable sheltering of investment income with rents from any source. Thus, the need for 543(a)(6) as a special class of personal holding company income has disappeared. Its continued existence presents difficulties and problems unrelated to the avoidance sought to be forestalled.

The original impetus for the enactment in 1937 of the predecessor to Section 543(a)(6) was that shareholders, in order to bring the percentage of investment income of their corporations below the 80 percent personal holding company test, would transfer to a corporation a yacht, city resident or country home, and pay sufficient rent to take the corporation out of the personal holding company classification. Further, the rent paid would usually be less than the actual cost of maintaining the property and frequently less than would have been received from an outsider in a bona fide transaction. By including as a separate category of personal holding company income amounts received from shareholders for the use of corporate property, Congress eliminated this method of tax avoidance.

This provision, which was designed to reach situations in which private property was incorporated to avoid personal holding company classification, resulted in inequities where property was leased by a corporation to stockholders for use in a business operation.

Accordingly, in 1950, this section was amended to provide that rents received between 1945 and 1950 for use by the lessee in the operation of a bona fide commercial or mining enterprise should not be included in personal holding company income. In 1954, the provision was further changed so that the rent received from a shareholder was not personal holding company income if the corporation had less than 10 percent of other perosnal holding company income.

During the period from 1937 to 1964, personal holding company income included rent, unless rent constituted 50 percent or more of total gross income. However, "rent" for the purpose of this test was defined to exclude amounts received for the use of corporate property by shareholders. (Section 502(g), 1939 Code; Section 543(a)(7), 1954 Code.) Until 1964, therefore, the provision relating to a shareholder's use of property (Section 502(f), 1939 Code; Section 543(a)(6), 1954 Code) had significance in preventing tax avoidance due primarily to the rent exclusion as then defined.

Enactment of the new personal holding company provisions in 1964 changed this long standing relationship. The new section departed from the 50 percent gross receipts test for rent and substituted a 50 percent of "adjusted ordinary gross income" test. In computing the adjusted income from rents for purposes of this test, gross rents are reduced by depreciation, interest, taxes and rent paid on the rental property. The new law included an additional test which requires other personal holding company income to be negligible or distributed as dividends. The only pertinent change made in respect to the shareholder's use of property was to apply the 10 percent test to "ordinary gross income" instead of "gross income."

The present tests for all practical purposes require a corporation to be engaged primarily in the rental business in order to avail itself of the rental exclusion. It is practically impossible to shelter investment income in a rental corporation in any significant amount under the present law.

The Internal Revenue Code then has come full circle in respect to a shareholder's use of corporate property. Prior to the enactment of this section in 1937, investment income could be sheltered by placing personal property in corporate form. From 1937 to 1964, it could be sheltered only by other rental property. Now, for all practical purposes, no rental property can shelter other investment income. The need for this special definition has now disappeared.

The 10 percent test under the present rent Section (543(a)(2) is the same as applied in the shareholder's use of corporate property (Section 543(a)(6)), except that, in the latter case, investment income cannot be reduced by the dividends paid. This difference in treatment seems illogical since the abuse sought to be forestalled is the same in both cases.

Elimination of an unneeded special definition from an already extremely difficult statute and its integration with the general rent definition would be helpful. In addition, it would eliminate problems of the type highlighted by Revenue Ruling 65-259 (1965-2 CB 174). The Service's attempt in this ruling to expand the definition of rents received from shareholders seems unnecessary if its objective is to prevent sheltering of investment income, but it seems to represent an effort to force more corporations, regardless of their activity, into the personal holding company net. The intent of Section 543(a)(6) when enacted and as subsequently amended clearly indicates an attempt to alleviate a specific abuse and not hamper normal commercial enterprise. The belated attempt to extend the definition does not appear to be based on these precepts.

The personal holding company provisions should be considered apart from other abuses which can arise due to control of corporations.

Estates, Trusts, Beneficiaries and Decedents

SECTION 642(H)

59. *Separate Shares—Partial Termination*

The deduction carryover provisions of Section 642(h) should be extended to the termination of a single beneficiary's entire interest in a trust having different beneficiaries where such interest represents a separate share as determined under Section 663(c).

The deduction carryover provision of Section 642(h) applies only upon the final termination of an estate or trust. The provision should be extended so as to include an apportionment of such deductions when there is a final termination as to a single beneficiary's separate share in a trust where there are several beneficiaries.

SECTION 642(H)

60. *Unused Investment and Foreign Tax Credits on Termination of an Estate or Trust*

The investment and foreign tax credits not used by the estate or trust should be available as a carryover to the beneficiaries succeeding to the property of the estate or trust.

Present law provides for the carryover of a net operating loss, a capital loss and the excess of deductions over gross income in the last taxable year to the beneficiaries succeeding to the property of the estate or trust. It is equitable for the beneficiaries also to be allowed the benefit of the unusued investment and foreign tax credits.

SECTION 643(A)

61. *Distributable Net Income*

Only the excess of corpus deductions over corpus "income" should be deductible in computing distributable net income.

A limiting factor in the amount of estate and trust income taxable to the income beneficiary is "distributable net income" as defined in Section 643(a). The effect of this definition is that all items of deductions (whether charged to corpus or to income) other than the personal exemption are deductible in computing distributable net income.

Thus, for example, the income taxable to the beneficiary of a simple trust (which requires that all income—as distinguished from corpus—be distributed currently), using the following assumed annual income and deductions, would be computed as follows:

Dividends and interest income (credited to income for trust accounting purposes)	$5,000
Short-term capital gain (credited to corpus for accounting purposes)	1,000
Gross income	6,000
Deductions:	
Legal expenses (charged to corpus)	500
Taxable income before deduction for distributions to beneficiary	5,500

Under Section 643(a) the deduction for distributions to beneficiaries is limited to \$4,500 (the \$5,000 dividend and interest income, less the \$500 legal expenses paid) and this is the only amount the income beneficiary would be taxed on, even though he was paid \$5,000, the full annual income for trust accounting purposes.

It can thus be seen that expenses paid which are charged to corpus for estate and trust accounting purposes normally reduce the amount of income taxable to the *income* beneficiaries. This is true even though corpus may be taxed in full on such items as capital gains. In the above example, the entire \$1,000 capital gain realized by *corpus* would be taxed (subject to allowance of the deduction for the trust's personal exemption) even though the \$500 legal expenses had paid by *corpus* during the year.

It is recommended that the definition of "distributable net income" be amended so that corpus deductions first be used to offset items of income taxable to corpus; only the excess should be deductible in computing distributable net income which is a measure of the amounts taxable to the income beneficiaries.

SECTION 663

62. Separate Shares—Estates

The separate shares rule should be extended to apply to estates as well as trusts when the estate has more than one beneficiary and the beneficiaries have substantially separate and independent shares in the assets of the estate.

Where any beneficiary of a trust having more than one beneficiary has a substantially separate share in the trust, each such beneficiary's share will be regarded as a separate trust for the purposes of determining the amount of income distributable to the beneficiary. As presently constituted, this provision applies only to trusts. It should be extended to include estates.

SECTION 663(a)

63. Corpus Distributions

The definition of the types of gifts and bequests which are excluded from the gross income of beneficiaries of estates and trusts should be liberalized.

Payments of certain specific bequests or gifts of specific sums of money or specific property are not deductible from distributable net income of the estate or trust. Such payments are not includable in the income of the recipient. However, other distributions of the same nature and character result in a distribution taxable income, and are taxed to the recipient, because they fail to meet the test of the exclusion in the Code. The Section 663 exclusion test should be liberalized to permit exclusion from income of a beneficiary of:

1. All bequests or gifts, unless payable solely from income, if paid all at once or within one taxable year of the estate or trust, or, in the case of installment payments, if distributed before the close of the 36th month after the death of the testator.
2. Any real property, tangible personal property (except money) or stock in a closely held corporation which is properly distributed within the 36 months following the death of the decedent.

SECTION 691

64. Income in Respect of Decedents

The income tax deduction for the estate tax attributable to income in respect of a decedent should be replaced by an estate tax deduction for the income tax attributable to such income.

The purpose of this Section 691(c) deduction is to relieve a double tax situation and place the decedent's estate or heir in the same position as the decedent would have been had he realized the income during lifetime and paid the income tax thereon. Present law provides for a deduction of an attributable portion of estate tax as an income tax deduction rather than an attributable portion of income tax on this income as a deduction for estate tax purposes. The provision of a deduction for income tax purposes, rather than an income tax deduction for estate tax purposes, appears to have been made for administrative expediency; it results in difficult and complicated computations, and can produce inequitable results.

It is recommended that the deduction permitted by Section 691(c) to persons who include in gross income, income in respect of a decedent under Section

691(a). should be replaced by rules which would permit a deduction for estate tax based upon the amount of income tax which would be deemed attributable to all items includible as income in respect to a decedent under Section 69(a), less deductions allowed under Section 691(b).

REGULATED INVESTMENT COMPANIES

SECTION 852(a)(1)

65. Deficiency Dividends for Regulated Investment Companies

If the taxable income of a regulated investment company is increased by the Internal Revenue Service, resulting in failure of the taxpayer to meet the requirement that 90 percent of its taxable income be distributed, the dividends-paid deduction should include deficiency dividends. similar to those determined under Section 547, if the taxpayer would have met the 90 percent requirement were it not for such increase.

Section 852(a)(1 requires payment of dividends amounting to 90 percent or more of the ordinary taxable investment income of a regulated investment company. An increase in the ordinary taxable investment income by the Internal Revenue Service could be of such an amount that 90 percent of the corrected ordinary taxable investment income will not have been distributed as a dividend. Under present law the regulated investment company would be disqualified in such case.

Where the regulated investment company did pay dividends of 90 percent or more of its ordinary taxable investment income without regard to the increase made by the Internal Revenue Service, thereby demonstrating good faith. provisions, such as those of Section 547, regarding deduction for deficiency dividends, should be made applicable.

Real Estate Investment Trusts

SECTION 857(A)(1)

66. Deficiency Dividends for Real Estate Investment Trusts

Where a real estate investment trust has acted in good faith in distributing 90 percent of its taxable income, the dividends-paid deduction also should take into account deficiency dividends, similar to those determined under Section 547, if the taxpayer's taxable income is increased upon examination so that the 90 percent requirement is not met.

Section 857(a) provides that a real estate investment trust must distribute 90 percent of its taxable income in dividends. It is possible that an examination by the Internal Revenue Service may change the taxpayer's taxable income significantly, resulting in a tax liability because, as a result of the increase in taxable income, the taxpayer does not meet the 90 percent requirement.

The provisions, such as those of Section 547, regarding deduction for deficiency dividends, should be made applicable with respect to situations in which a Service examination causes a real estate investment trust to fall below the 90 percent requirement when prior to the examination the trust had, in good faith, distributed 90 percent of its taxable income.

Tax Based on Foreign Income, Etc.

SECTIONS 862, 904, 911

67. U.S. Partners Stationed Abroad

Guaranteed payments to a U.S. citizen who is a member of a partnership and is stationed abroad should be treated as made to one who is not a member of the partnership under Section 707(c) for purposes of Sections 862, 904, and 911.

Section 911 of the Internal Revenue Code provides that a U.S. citizen employed abroad who meets the tests of Section 911(a)(1) or (a)(2) is permitted to exclude up to $20,000 or $25,000 of earned income as the case may be, regardless of where his employer derives his income. The source of the employee's earned income is the place where the services are performed. If all of his services are performed outside the United States his entire compensation is treated as foreign source income for purposes of Sections 862 and 904, as well as for the exclusion under Section 911. On the other hand, a partner who performs his services without the United States is not considered by the Treasury Department to earn his income at the place where the services are performed, but rather the source of his distributive share of partnership profits is determined where the partnership earns its income. If the partnership income is earned both within and without the United States, then the Treasury Department contends the partner has received a proportionate part of his partnership share from sources within the United States even though all of his services are perfromed outside the United States. (See *Foster*, 329 F. 2d 717, and *Foster*, 42 TC 974). The usual result of this approach is that the Section 911 exclusion is effectively lost even though there is nothing in the legislative history of Section 911 which reveals a purpose to discriminate between partners and employees.

The problem is further aggravated by the fact that a U.S. citizen employee in a foreign country will report his income in excess of the $20,000 or $25,000 limit as foreign source income since his services are performed abroad, subject to a foreign tax credit under Section 901. In contrast, a partner is frequently faced with double taxation where the country of residence imposes its income tax on his full distributive share of partnership profits. To the extent that his distributive share is considered derived from U.S. sources he is denied a foreign tax credit in the United States.

There is no justification for the different tax treatment of income earned from the performance of personal services abroad depending solely upon whether the individual is an employee or a partner.

To remedy this situation, it is recommended that Section 707(c) be amended to provide that guaranteed payments to a partner for services shall be considered as made to one who is not a member of the partnership, not only for purposes of Section 61(a) and Section 162(a) as presently provided, but also for purposes of Sections 862, 904, and 911. Thus, a partner who receives a stated salary for performing services outside the United States could, for that portion of his income from the partnership, receive U.S. tax treatment similar to that accorded employees.

SECTION 902(b)

68. Deemed Foreign Tax Credit

The deemed foreign tax credit should be liberalized by (1) permitting the credit with respect to foreign corporations lower than the second tier, and (2) lowering the 50 percent ownership requirement for any lower-tier corporation to 25 pecent, but with the requirement that the domestic corporate shareholder have at least a 5 percent ultimate beneficial ownership of voting stock in any lower-tier corporation.

A U.S. corporate shareholder may claim a deemed foreign tax credit in the situation where it owns 10 percent of the voting stock of a first-tier foreign corporation and the first-tier corporation owns at least 50 percent of the voting stock of a second-tier foreign corporation. Credits from tiers lower than the second are now not considered regardless of the degree of ownership.

Because of the business conditions that exist today it is necessary in many cases to have local nationals own more than 50 percent of the stock of foreign corporations. Furthermore, the corporate structures of foreign investments are becoming increasingly complex as the result of such factors as circumstances existing at the time of acquisition and specialized business arrangements. In situations such as these, it seems unfair that the U.S. corporate shareholder should lose the foreign tax credit.

To remedy this condition, it is suggested that the deemed foreign tax credit should be permitted with respect to any lower-tier foreign corporation which has at least 25 percent of its voting stock held by a corporation in the tier above it.

It is recognized that this proposed rule could, as the result of numerous successive tiers, result in a deemed foreign tax credit in a situation where the ultimate beneficial ownership by the U.S. corporate shareholder is insignificant. To avoid this possibility, there should be a requirement that the U.S. corporate shareholder have at least a 5 percent ultimate beneficial ownership of voting stock in any lower-tier corporation. This 5 percent is the same as the minimum ultimate beneficial ownership which is required under present law with respect to a second-tier subsidiary (10 percent of 50 percent).

SECTION 904(b)

69. Revocation of Election of Overall Limitation

A taxpayer should have the right to an annual election to use the overall limitation or the per-country limitation on the foreign tax credit. In addition, a change in the original election should be permitted at any time within the statutory period of limitations applicable to the taxable year of such election.

Section 904 allows a taxpayer to elect an overall limitation effective with any taxable year beginning after December 31, 1960. Once a taxpayer has made an election to use the overall limitation, that election is binding in all subsequent years, except that it may be revoked with the consent of the Commissioner of Internal Revenue. There is one exception. For the first year for which an election can be made, the taxpayer may make the election to use the overall limitation or may revoke an election previously made for that year, if such election or revocation (as the case may be) is made before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed for such taxable year.

The election of the overall limitation or the per-country limitation on the use of the foreign tax credit is not a method of accounting but rather a means of computing tax liability. Since a method of accounting is not involved, there is no reason to require the consent of the Commissioner before a change in the election may be made. There are a number of reasons why a change may be necessary after the original election is made; for example, where substantial losses are realized with respect to existing investments because of nationalization, expropriation or war or where a taxpayer expects to enter substantial operations in a new foreign country and anticipates such operations will result in a loss for a number of years.

In the interest of equity and simplicity, it seems preferable that taxpayers be given the right to an annual election to use the overall limitation or the per-country limitation on the foreign tax credit. However, the prohibition of Section 904(e)(2) on carrybacks and carryovers between per-country and overall limitation years would continue to apply. A change in the original election should be permitted at any time within the statutory period of limitations applicable to the taxable year of the original election, without first securing the consent of the Commissioner.

SECTION 904(d)

70. Carryback and Carryover of Excess Tax Paid

The definition of the amount of carryback and carryover of foreign tax credit should be changed so that the amount involved is the difference between the foreign tax paid or accrued and the foreign tax used as a credit. As presently defined the amount involved is the difference between the foreign tax paid or accrued and the applicable limitation under Section 904(a).

Due to the formula provided in Section 904(d) for the determination of the amount of foreign taxes paid or deemed to have been paid which can be used as a carryback or carryover, taxable income derived from two or more foreign countries can be subjected to double taxation. This will occur when the taxpayer has a loss from U.S. operations and uses the per-country foreign tax credit limitation. It does not occur when the overall limitation is used. Such double taxation results from a portion of the foreign taxes not being available for use either as a current credit or a carryback-carryover credit.

In the following example the foreign source income as reduced by the U.S. loss is taxed at an effective rate of 64 percent. This would not occur if the amount of an unused foreign tax credit available as a carryback or carryover was defined to be the difference between the foreign tax paid or accrued and the foreign tax used as a credit.

	Income (loss)	U.S. tax	Foreign tax
Foreign country A	$100		$60
Foreign country B	100		55
United States	(50)		
Total foreign tax			115
Total income per U.S. return	150		
U.S. tax at 48 percent before foreign tax credit		$72	
Foreign tax credit per-country limitation ($)—			
Country A: 100/150×72 equals	48		
Country B: 100/150×72 equals	48		
Credit limitation	96		
Foreign tax credit (lesser of $72 or $96)		72	72
U.S. tax payable		0	
Unused foreign tax			43
Available credit carryback—carryover under sec. 904(d):			
Country A ($60—$48)			12
Country B ($55—$48)			7
Total available			19
Erosion of unused foreign taxes available for foreign tax credit ($43—$19)			24
Effective combined tax rate on net taxable income of $150 (U.S. tax of $72 plus eroded foreign taxes of $24=$96÷$150) (or U.S. tax rate of 48 percent plus rate of unavailable foreign taxes of 16 percent ($24÷$150) (percent)			64

SECTION 904(d)

71. Carryback of Excess Foreign Taxes

The two-year carryback of the excess of foreign income, etc., taxes paid over the applicable limitations in Section 904 should be changed to three years.

Section 904(d) provides that any excess of foreign income, etc., taxes paid over the applicable limitations contained in other parts of Section 904 is carried back two years and then forward five years.

The carryback and carryover principle is employed in other parts of the Internal Revenue Code. Widespread application occurs in the areas of the net operating loss and the unused investment credit. In both of these situations, a nine-year business cycle has been deemed by Congress to be most appropriate (i.e., the taxable year, three years back and five years forward). It appears that the same nine-year cycle would also be most appropriate in connection with excess foreign income taxes. Such conformity would be achieved by changing the foreign tax carryback from two years to three years.

SECTION 911(a)(2)

72. Exclusion of Earned Income From Sources Without the United States

The exclusion from gross income of earned income from sources without the United States attributable to presence in another country for seventeen months granted by Section 911(a)(2) should be allowed for resident aliens.

In general, the tax laws do not distinguish between *resident aliens* and United States citizens. In one important respect, there is a difference in treatment which results in an inequity to the resident alien.

A resident alien is taxed on his global income just as a citizen. However, if the alien works for an extended period of time outside the United States, he is taxed more severely than any citizen since he is not permitted the earned income exclusion under Section 911(a)(2). There is no basis in reason or equity for this distinction.

The section should be amended to permit the exclusion for resident aliens as well as for citizens.

SECTION 958

73. Controlled Foreign Corporation Defined

Section 958 should be amended so that it is not possible for second-tier and lower-tier subsidiaries to be controlled foreign corporations where the first-tier foreign corporation is not a controlled foreign corporation.

Section 957(a) defines a "controlled foreign corporation" (CFC) as any foreign corporation of which more than 50 percent of the total *voting power* of all classes of stock is owned or considered as owned within the meaning of Section 958 by U.S. shareholders. Therefore, a first-tier foreign corporation is not a CFC where more than 50 percent *in value* of its stock is owned by U.S. shareholders, provided the U.S. shareholders do not meet the *voting power* test. However, in such a case, although the first-tier foreign corporation is not a CFC, foreign subsidiaries in which the first-tier foreign subsidiary owns more than 50 percent of the total voting power are CFCs. This result, apparently contrary to Congressional intent, is determined as follows:

1. Section 958 provides that for purposes of determining whether a corporation is a CFC under Section 957, the constructive ownership rules of Section 318(a), as modified, shall apply.

2. Section 318(a)(2)(C) as modified by Section 958(b)(3) provides that if 10 percent or more in value of the stock of a corporation is owned, then the owner shall be considered as owning any stock owned by that corporation in the proportion which the *value* of the stock owned in the first corporation bears to the *value* of all of the stock of such corporation.

3. When applying Section 318(a)(2)(C), Section 958(b)(2) provides that if a corporation owns more than 50 percent of the voting power of all classes of stock entitled to vote, it shall be considered as owning 100 percent of the stock entitled to vote.

An example to illustrate the application of the cited Code sections follows. Assume foreign corporation F owns 60 percent of the one class of outstanding stock of foreign corporations X and Y, and Y owns 60 percent of the one class of outstanding stock of foreign corporation Z. The ownership in F is as follows:

	Number of shares			Percent of ownership	
	Total	Class A (nonvoting)	Class B (voting)	Voting	Value
U.S. shareholder	550	150	400	48	55
Foreign shareholders	450	25	425	52	45
Total	1,000	175	825	100	100

The application of the various sections is as follows:

1. F is not a CFC since U.S. shareholders do not own more than 50 percent of its voting power.

2. Under Section 958(b)(2), F is considered to own 100 percent of X and Y, and Y is considered to own 100 percent of Z when applying Section 318(a)(2)(C).

3. The U.S. shareholder under Section 318(a)(2)(C) is considered to own 55 percent of the stock of corporations X, Y and Z; thus, they are CFCs.

To remedy this condition, Section 958(b)(3) should be modified to read: "In applying subparagraph (C) of Section 318(a)(2), the phrase '10 percent' shall be substituted for the phrase '50 percent' and the phrase 'voting power' shall be substituted for the word 'value' used in subparagraph (C)."

Gain or Loss on Disposition of Property

SECTION 1091

74. *Wash Sales*

The wash-sale provision should apply to security traders (but not to dealers) whether or not incorporated.

Section 1091, as presently written, disallows wash-sale losses incurred by taxpayers other than corporations only if such losses would be deductible under Section 165(c)(2). Section 165(c)(2) provides for the deductibility of "losses in curred in any transaction entered into for profit, though not connected with a trade or business." It is clear that, for such taxpayers, security losses incurred in a trade or business, deductible under Section 165(c)(1), are not affected by the wash-sale rule.

It has been held that taxpayers whose business it is to buy and sell securities for a speculative profit may deduct their losses under Section 165(c)(1) and are, therefore, exempt from Section 1091. Such taxpayers are called traders and are to be distinguished from security dealers who maintain an inventory and sell to customers in the ordinary course of their trade or business. Traders, although holding their securities for sale, are not merchants and may not inventory their positions because they sell them through brokers and not to customers (Regulations Section 1.471-5). It is also pertinent to note that, in the case of corporations, Section 1091 is operative except as to losses incurred in the ordinary course of the business of a corporate security dealer.

The special treatment given to noncorporate traders is not warranted and gives such taxpayers an unfair advantage over noncorporate investors and over corporations active in the purchase and sale of securities. Even though this exemption is of long standing, a persuasive case can be made for the position that it arose in the first place as a result of a misunderstanding. For a complete discussion of the background of this section, see S. Walter Shine, "Wash-Sale Losses—A Gift to Security 'Traders,'" *Taxes*, June 1954, p. 455. The article indicates that the original intention was to limit the exemption to dealers because they could inventory their positions. Since dealers may, under an appropriate inventory method, avail themselves of unrealized losses in their inventory, the application of the wash-sale rule to them is unnecessary. This interpretation of the original intent is logical, while the extension of the exemption to traders who may not inventory their positions is not. Furthermore, the distinction between corporate and noncorporate traders is similarly illogical and casts doubt upon the correctness of the latter's exemption.

It should also be noted that the factual determination of who is or is not a trader has caused considerable difficulty at administrative levels of the Internal Revenue Service. Inequitable decisions are bound to occur because of the problem of determining whether or not a particular taxpayer's buying and selling activities are sufficient to constitute the carrying out of a trade or business. This administrative burden, with necessarily varying results among taxpayers in borderline cases, is not warranted in administering a law that appears to be illogical. For these reasons, Section 1091 should be amended so that it is applicable to all taxpayers except with respect to transactions in the ordinary course of the trade or business of security dealers.

Capital Gains and Losses

SECTION 1201

75. *Capital Gains: Alternative Tax*

Section 1201 should be amended to provide that the alternative tax should not exceed 25 percent of the amount of net taxable income when such net income is attributable to net long-term capital gains.

The tax liability of an individual or a corporation having an excess of ordinary deductions over ordinary income (an ordinary loss), and a net long-term capital gain in excess of such ordinary loss, is based upon the lesser of:

1. Tax computed by applying the regular rates to taxable income (net long-term capital gain reduced by ordinary loss); or
2. The alternative tax which is 25 percent of the net long-term capital gain.

Irrespective of which calculation provides the lower tax, the ordinary loss is absorbed by the net long-term capital gain. In some instances, this results in the taxpayer's receiving no benefit from the ordinary loss.

The following example illustrates the point:

A corporation has net taxable income of $75,000 for 1968 comprised of net long-term capital gain of $100,000 and an ordinary operating loss of $25,000. Its tax (before computation of the tax surcharge and adjustments for credits against the tax, etc.) is $25,000, which represents the lesser of the alternative tax of 25 percent on the entire net long-term capital gain, or the normal tax and surtax of $29,500 on its net taxable income. If the corporation had realized only the net long-term capital gain (zero ordinary operating income or loss), its tax would also be $25,000. Clearly, therefore, it has had no tax benefit from its ordinary operating loss of $25,000.

The 25 percent maximum alternative tax should be applied to net taxable income if such income is less than the net long-term capital gain. In the foregoing example, this treatment would result in an alternative tax of $18,750 (25 percent of $75,000).

SECTION 1211(b)

76. *Capital Loss Limitation—Joint Returns*

Section 1211(b) should be amended to extend the limitation on capital losses deductible on joint returns to $2,000.

Under section 1211(b) individuals are presently limited in deduction of capital losses to the amount of their gains from the sales of capital assets plus the taxpayer's taxable income or $1,000, whichever is the lesser. Husband and wife who file a joint return presently have their income and deductions aggregated and for purposes of Section 1211(b) are treated as one taxpayer.

For married taxpayers in noncommunity property states the capital loss limitation is $1,000, except in rare instances where spouses in fact have essentially equal income and separately taxable gains and losses from capital assets. By contrast, in community property states whenever a capital loss is incurred by the community, a husband and wife can obtain a current year deduction of $2,000 for capital losses against ordinary income by filing separate returns.

The filing of separate returns by husband and wife in community property states for the purpose of obtaining the current deduction of capital losses against community income creates inconvenience and difficulty for both the Internal Revenue Service and the taxpayers. Compliance, enforcement and data processing are hampered by the year to year change from joint to separate returns which often occurs.

Even more to the point is the contention that Section 1211(b) speaks of the "taxpayer" of which there are in fact two on any joint return. If the Internal Revenue Code is to fully recognize income splitting for spouses in both community and noncommunity property states, as it otherwise has been doing since 1948, then extension of the capital loss limitation to $2,000 on joint returns is the only logical recourse.

As the allowable term during which a capital loss may be carried over to subsequent years is essentially unlimited under present Section 1212(b) the entire loss will eventually be deductible in noncommunity joint returns. Any acceleration of this deduction through an increase to the proposed $2,000 limitation would not cause any significant loss of revenue to the Treasury Department over the long term.

SECTION 1232

77. *Capital Loss Treatment of Bad Debts*

Section 1232 should be amended to exclude any loss resulting from partial uncollectibility of an advance to a company which is an affiliate as defined in Section 165(g)(3).

Section 1232 provides for capital gain or loss treatment on the retirement of indebtedness issued by any corporation or government or political subdivision thereof. Under the 1939 Code, the treatment was limited to indebtedness issued with interest coupons or in registered form. The 1954 Code dropped this requirement and extended the capital gain or loss treatment to all corporate and government "bonds, debentures, notes, or certificates or other evidences of indebtedness" issued on or after January 1, 1955, which are capital assets to the taxpayer.

Because of the 1954 change, certain items that could previously be deducted as bad debts under Section 166 may now be capital losses under Section 1232. For example, if Corporation A, for good business reasons, makes a loan to Corporation B, which is evidenced by a note, and Corporation B is subsequently able to repay only a portion of the loan, Corporation A might have a capital loss on the retirement of the indebtedness (assuming that the note is a capital asset in the hands of A). Although the Committee Reports on the 1954 Code give no indication one way or the other, it seems unlikely that this result was intended in the case of affiliated corporations. Therefore, Section 1232 should be made inapplicable to loans to affiliates, as defined in Section 165(g)(3), which otherwise would qualify as business bad debts under Section 166.

SECTION 1244

78. *Qualification as Section 1244 Stock*

The requirement that Section 1244 stock be issued according to a plan should be eliminated.

Several court decisions have denied ordinary loss treatment to shareholders of small business corporations. In these cases, the stock qualified as Section 1244 stock within the meaning of Section 1244(c), except that the corporation records did not document the existence of a plan at the time of issue.

The limitation of the benefits of Section 1244 to taxpayers who insert certain phraseology in corporate records undue emphasis on form and is inconsistent with the objectives of the Small Business Tax Revision Act of 1958. Stock otherwise qualifying under the terms of Section 1244(c) should be treated as Section 1244 stock regardless of the existence of a plan.

Readjustment of Tax Between Years and Special Limitations

SECTION 1321

79. Involuntary Liquidation of LIFO Inventory

Rules regarding involuntary liquidation of LIFO inventories should be permanently extended to cover all conditions and circumstances beyond the reasonable control of the taxpayer which, directly or indirectly, prevent the acquisition of inventory.

The LIFO inventory method is based on the realistic business fact that a going business must maintain a "fixed" minimum inventory position in order to continue functioning effectively. Based on this assumption, Congress has provided special rules covering LIFO inventories involuntarily liquidated during wartime and similar emergency periods. In these circumstances, the liquidation must have been the result of the prevailing emergency conditions in order to invoke the special rules providing for replacement of the liquidated LIFO inventory at a tax cost basis equivalent to that of the inventory formerly held.

Similar conditions completely beyond the reasonable control of the taxpayer may exist in periods other than those of national emergency which may effectively prevent maintenance of the normally required inventory by a particular taxpayer. Such conditions, for example, might include events such as fires and floods, as well as economic happenings such as strikes, peculiar to the particular taxpayer.

In view of this, the Code should be amended to provide permanent rules covering the involuntary liquidation of LIFO inventory caused by circumstances and conditions beyond the reasonable control of a taxpayer. Sufficient safeguards should be enacted to make certain that the liquidation is the result of such circumstance or condition, and that it is not simply a coincidental event.

Election of Certain Small Business Corporations as to Taxable Status

SECTIONS 1371–1378

80. General Comment—Subchapter S

The Subchapter S election has proved to be substantially less useful than was originally intended because of execessively complex and restrictive rules within the statute itself and because of narrow and rigid interpretation by the Treasury Department. There is a need for major revision of the Subchapter S provisions in order to make them of more general benefit to those for whom the election was intended.

On February 5, 1969, the House Ways and Means Committee and the Senate Finance Committee jointly published a three-volume work entitled "Tax Reform Studies and Proposals—U.S. Treasury Department." Included in the work is a proposal regarding Subchapter S corporations resulting from a joint study undertaken by the Treasury Department and the Committee on Partnerships of the American Bar Association's Section of Taxation. On April 22, 1969, the identical proposal was presented to the Ways and Means Committee by the Treasury Department as part of President Nixon's tax program.

In general, this proposal presents a very useful approach to the problem. It has the highly desirable basic aims of treating Subchapter S corporations as much like partnerships as is possible and of removing unnecessary restrictions and complications. Certain modifications, however, are desirable. These are as follows: greater flexibility should be granted Subchapter S corporations in the use of fiscal years; the treatment of retirement plans for partners of partnerships and shareholders of Subchapter S corporations should conform with that presently provided for corporate executives; and, the separate character of certain items of income and deductions should be retained in the hands of Subchapter S corporation shareholders in order to bring the tax treatment of Subchapter S corporations still closer to that of partnerships.

Estate and Gift Taxes

SECTION 2014(b)

81. *Credit for Foreign Death Taxes*

The limitation on the amount of foreign death taxes creditable against federal estate tax should, at the option of the taxpayer, be determined on an overall basis.

Section 18 of the Revenue Act of 1962 amended prior law to eliminate the exclusion from the gross estate of real property situated outside of the United States. This increase in the ambit of federal estate taxation focuses attention on the goal of avoiding double taxation of estates.

The amount of foreign death taxes creditable against federal estate tax is the lesser of two amounts under limitations computed on a per-country basis. In 1960 Congress amended the foreign income tax credit provision in order to give taxpayers an election to compute that credit on either a per-country basis or an overall basis. The same election should be available to fiduciaries of estates with assets in more than one foreign country.

SECTIONS 2031, 2032, 2512(a)

82. *Valuation of Property for Estate and Gift Tax*

The value of property for estate and gift tax purposes should never be greater than the amount that could in fact be realized by the donor or decedent's estate.

The Internal Revenue Code bases the gift tax on the value of the gift. This has been defined in the regulations as the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.

Regulation Sections 20.2031-8(b) and 25.2512-6(b) now provide that for gift tax purposes (as well as for estate tax purposes) shares of an open-end investment company (mutual fund) are to be valued at the "public offering price" (asked price), which generally includes a loading charge. These regulations have been held valid by the courts in *Estate of Frances F. Wells*, 50 TC 871 and *Howell*, 290 F. Supp. 690, respectively. However, these holdings appear to be unreasonable. The valuation should be based on the "redemption price" (bid price) quoted for such shares by the company, which is all the donor (or the executor) could realize on disposal.

The Treasury has also amended the Gift Tax Regulations (and the Estate Tax Regulations) in regard to the definition of the value of gifts of property if the item of property is generally obtained by the public in the retail market. The fair market value is then the price at which the item or a comparable item would be sold at retail. This provision is inequitable for the same reason cited for mutual fund shares in that it could impose a higher valuation for gift and estate tax purposes than could be realized by the donor (or the decedent's estate).

It is recommended that the provisions of Section 2031, 2032 and 2512(a) be clarified to provide that in no instance could the value of property subject to estate or gift tax be greater than the amount that could in fact be realized by the donor or decedent's estate.

SECTION 2042

83. *Reversionary Interests—Insurance*

The provisions relating to the 5 percent reversionary interest should be limited to those situations where the decedent retained a reversionary interest. Any interest that arises through inheritance or operation of law should be excluded from applicability.

Present law provides for the inclusion of the value of insurance receivable by beneficiaries other than the executor in the gross estate of the decedent where the decedent had any of the incidents of ownership in the policy. "Incident of ownership" includes a reversionary interest if its value is more than 5 percent of the value of the policy immediately before death. In determining the value of the reversionary interest, the possibility that the policy or its proceeds may revert to the decedent by reason of operation of law should not be considered since he decedent would have no control over this factor.

SECTION 2503(c)

84. Exclusion for gifts of certain future interests

The annual $3,000 gift tax exclusion should be extended to all gifts of a future interest where the property will be used solely for the benefit of a specified donee during his life and the remainder of the property, if any, will on his death be included in his gross estate.

Section 2503(c) provides the conditions under which a transfer for the benefit of a donee under age 21 on the date of the gift will not be considered a gift of a future interest in property, and for which, therefore, the annual $3,000 gift tax exclusion will be allowed. Basically, these conditions are that the corpus of the gift, together with any undistributed income, be completely distributed to the donee at age 21. Criticism of Section 2503(c) has been directed to the requirements that the donee must be under age 21 and that there must be complete distribution of undistributed income and corpus at age 21.

It is proposed that Section 2503(c) be amended to permit a transfer to a donee, without regard to age, that income need not be distributed currently and that corpus may be retained in the trust, provided that to the extent that income and corpus are not distributed to or expended for the benefit of the donee during his life, they be payable on his death either to his estate or as he may appoint under a general power of appointment as defined in Section 2514(c). The retained income and corpus thus will be included in the beneficiary's gross estate on his death, eliminating any possible loss of estate tax revenue.

SECTION 2504(c)

85. Valuation of gifts made in prior years

The prohibition of an adjustment of the value of gifts made an exclusions allowable in prior years where the statute of limitations has expired should not depend upon the payment of a gift tax.

Section 2504(c) now provides that the value of a gift made in a prior year cannot be readjusted in subsequent years if the gift tax was actually paid on the gift made in the prior year and the period of limitations for assessment has expired for such year. This requires that taxable gifts (gifts in excess of the allowable exclusions and deductions) must have been made in the prior year in order for the prohibition against the adjustment in value to be applicable.

It appears illogical not to permit the same prohibition to apply where no tax was payable because the allowable exclusions and deductions equalled or exceeded the value of the annual gifts made. It, therefore, is proposed that this section be amended to prohibit the adjustment of the value of the taxable gifts made in prior years as well as the amounts excluded, if any, with respect to such gifts, so long as a gift tax return has been timely filed.

Procedure and Administration

SECTION 6081

86. Automatic Extension of Filing Time for Certain Individual Returns

A provision similar to that now available to corporations for automatic extension of time for filing corporation income tax returns should be enacted to cover certain individual and fiduciary income tax returns.

The increasing complexities of the tax laws, the greater burdens of compliance caused by the complex tax laws, expanded use of electronic data processing, and the growing problem of securing professional help have made it difficult for many taxpayers to file a professionally prepared return on a timely basis.

Senate Report No. 1622 (83rd Congress, 2nd Session) accompanying H.R. 8300 (Internal Revenue Code of 1954) states that the postponement to April 15 of the date for individuals to file their income tax returns would "greatly relieve the difficulties taxpayers now have in preparing their returns by the present filing date," (i.e., March 15). The Report also provided that the postponement " . . . should also result in the filing of more carefully prepared returns . . . and should be beneficial to those who aid taxpayers in making out their returns." Unfortunately, this was not to be, the result.

All statistical information available indicates that the number of individual taxpayers who encounter some complexities in preparing their returns has increased substantially over the past few years and is expected to increase at an even more rapid rate in the future.

The time required for the preparation of a personal income tax return increases year by year. Present returns require details of dividend and interest income; there are now special forms for such items as exclusion of sick pay, employee business expenses, moving expenses, etc.; if there is an indicated underestimation of tax, Form 2210 should be attached; if income averaging is applicable, additional computations and schedules are required; the instructions call for substantial data in support of deductions for contributions of property.

With the expanded use of ADP by the Service, taxpayers are very anxious, and properly so, that amounts reported on all types of information returns agree precisely with amounts reflected in their returns. However, since Forms W-2 and 1099 are not required to be furnished to taxpayers until the end of January or February, the period in which returns must be prepared is significantly shortened.

Under Section 6081(a), the Secretary or his delegate *may* grant a reasonable extension of time for the filing of an individual income tax return. Regulations Section 1.6081(b) provides that a taxpayer must submit an application for such extension containing, among other things, "a full recital of the reason for requesting the extension." The Service must then determine whether the cited reasons merit the granting of the extension required.

The Internal Revenue Service has co-operated to the extent possible, administratively, to assist taxpayers by providing a policy for handling requests for extensions of time for filing individual returns. This administrative policy, while helpful, is still inadequate.

The majority of cases where extensions are needed for filing individual returns are those involving income from the operation of a trade or business, income from farming, income from business partnerships, joint ventures, pools or syndicates, and income from electing small business corporations (Subchapter S corporations). Similar problems may affect income tax returns filed by estates and trusts. The filing problems arising in these situations frequently are more acute than those affecting many corporations.

Section 6081(b) added to the Internal Revenue Code in 1954 provides for an automatic three-month extension of time for the filing of a corporative income tax return, merely upon application on a prescribed form (Form 7004) properly executed, timely filed, and accompanied by a remittance of estimated tax as prescribed in Regulations Section 1.6081-3(a)(2).

The existing situation with respect to certain individual and fiduciary returns can only be remedied adequately by legislation similar to that enacted in 1954 regarding automatic extensions of time for filing corporate income tax returns.

Provision for a two-month extension for the individual returns noted above involving business income would be contingent upon the filing of an application on a form comparable to Form 7004 accompanied by a remittance of the full amount of tax estimated to be due (except for returns filed by estates where present law permits quarterly payment of tax).

SECTIONS 6405(a), 6405(c)

87. Reports of Refunds and Credits

Section 6405(a) and (c) of the Internal Revenue Code should be amended to increase the dollar limitation therein to $250,000.

Section 6405(a) and (c) provides, in effect, that reports must be submitted to the Joint Committee on Internal Revenue Taxation whenever tax refunds or credits exceed $100,000. Legislative history reveals that a $75,000 limitation was first imposed under the Revenue Act of 1928. It was raised to $200,000 in 1949 and reduced to $100,000 in the Internal Revenue Code of 1954. Committee reports are silent as to the 1954 reduction in the limitation.

The preparation and review of Joint Committee reports are costly and time consuming procedures. The requirement of these reports in the present framework of the Internal Revenue Service's activities as a necessity for equitable administration of the tax law should be reexamined. In view of present economic conditions it is unrealistic to maintain a dollar limitation enacted 15 years ago. This dollar limitation should be raised to $250,000.

SECTION 6411

88. Tentative Carryback Adjustments—Foreign Tax Credits

Tentative carryback adjustments should be permitted for unused foreign tax credits, in the same manner as now provided for loss and investment credit carrybacks.

Section 6411 now permits taxpayers with net operating loss or unused investment credit carrybacks to file applications for tentative carryback adjustments (so-called "quick" claims) within 12 months of the close of the year in which the carryback arose. The amount of tax decrease resulting from the carryback must be refunded or credited within 90 days, subject to the right of the Service to disallow the application in the case of material errors or omissions. The tentative allowance is subject to adjustment upon audit of the taxpayer's return. This provision originally applied only to net operating loss carrybacks, and was extended to unused investment credit carrybacks in 1966.

The tentative adjustment procedure is designed to relieve taxpayers entitled to tax refunds from the economic burden of waiting until the audit of their tax returns is completed. Since examination of returns involving foreign income and tax credits is likely to be even more protracted than the usual audit, it appears logical that tentative adjustments of unused foreign tax credits also be permitted.

SECTION 6511(d)(2)

89. Statute of limitations on refunds arising from net operating loss carrybacks

Claim for refund with respect to a net operating loss carryback should be timely if filed within three years from due date, *including extensions*, of the return for the loss year.

If a taxpayer secures an extension for filing the tax return for a loss year, the statute of limitations on assessment will be extended to three years following the extended due date. Under Section 6511(d)(2), however, claim for refund based on carryback of the net operating loss must be made not later than three years following the *original* due date of the return for the loss year. Thus a gap is created during which assessment may be permitted but adjustments giving rise to additional refunds are barred.

This gap should be eliminated by providing that a refund claim based on a net operating loss carryback will be timely if filed not later than the expiration of the statute of limitations for assessment of tax with respect to the loss year.

SECTION 6601

90. Interest on an underpayment on form 7004

It should be made clear that, where a corporation has obtained an extension of time for filing its income tax return under Section 6081(b), interest will be charged on an underestimate only to the extent that the correct first installment exceeds the amount actually paid as a first installment.

A corporation is entitled to an automatic extension of time for filing its income tax return upon the filing of Form 7004 and the payment of one-half the estimated amount of its tax. Interest is quite properly charged where the corporation's estimate of its tax is less than the tax which is ultimately shown on is return. However, the amount of such interest is computed on a basis which is inequitable. The Internal Revenue Service takes the position that interest should be computed as if the Form 7004 were a final return. Thus, it computes interest on the excess of the final tax over that shown on Form 7004 just as if the Form 7004 were a return. The historical practice, before the enactment of Section 6081(b) was to charge interest only on the difference between the correct first installment and the amount paid as a first installment. This historical practice should be the present law.

The effect of the present practice is that an interest charge would be asserted under the following circumstances where no actual underpayment was involved:

Tax estimate per form 7004	$100,000
Installment paid with form 7004	75,000
Tax per form 1120 (final tax)	150,000

Under these circumstances, the Treasury's position is that interest should be computed for three months on $25,000 (the difference between half the final tax and half the amount shown on the Form 7004).

SECTION 6672

91. 100 Percent penalty for failure to collect and pay over tax

The enforcement of collection of a penalty under Section 6672 should be stayed during a period of judicial review and determination if the taxpayer posts a bond equal to 150 percent of the unpaid amount of the penalty sought to be assessed and collected.

The penalty imposed by Section 6672 applies only to the collection, accounting for, or payment over of all taxes imposed on a person other than the person who is required to collect, account for and pay over such taxes. The Secretary of the Treasury or his delegate is given the right to assess and collect such taxes without judicial review. Judicial review cannot be hed until at least a partial payment is made and suit instituted for recovery of the amount so paid.

Extreme hardships could result from the application of this section. It is possible that appreciated assets would have to be sold, resulting in the payment of income taxes on the profit, when a court might hold that there was no liability on the taxpayer for the penalty. Equity would demand that a person from whom amounts are sought to be collected under Section 6672 should have a right to post bond until such time as his liability is determined by judicial process. The posting of a bond of one and one-half times the amount of the tax would fully protect any loss of revenue which could be occasioned by delay in collection procedures.

The CHAIRMAN. The next witness is Mr. Richard Goldman, tax counsel for the Association of Mutual Fund Plan Sponsors, Inc.

STATEMENT OF RICHARD L. GOLDMAN, TAX COUNSEL, ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.

Mr. GOLDMAN. Mr. Chairman and members of the committee, I appreciate the privilege of appearing before you.

I am Richard L. Goldman of New York.

You are preparing a tax reform bill. I appear to call your attention to a reform, a perfecting amendment involving no revenue loss which is badly needed, and by many small and unsophisticated investors. There are nearly 2 million of them.

The amendment could be added as section 517 of your bill after "Other Changes in Capital Gain Treatment."

It relates to capital gains too. There is a threat of two capital gains taxes on one gain, and perhaps one gains tax on no gain due to a technical snarl, but this could be reformed easily.

I am talking about mutual fund investors who do not have large capital to invest, and so buy shares of a mutual fund under a periodic payment plan paying perhaps $25 a month for a period of years.

Each group of people making periodic payments to invest in a particular mutual fund are imagined to be an association equivalent to a corportion, and that is why there is trouble. They are regarded as an association because they all pay their money to a bank custodian which buys the fund's shares for them. The bank is regarded as if it were a central management like the management of a real corporation. Actually it does not manage. It couldn't just switch the investor's money into a different mutual fund. It is there because it is required by the SEC rules as a watchdog for the investors to act in emergency. For example, if the mutual fund stopped making shares available for purchases.

Nevertheless, an association is imagined to exist, and corporate rules are applied to it. The troubles that result involving double capital gain taxes are these.

When a periodic payment investor wants to liquidate his interest, he normally tells the bank to sell his shares back to the fund and send him the cash including the gain. He pays taxes on the gain. The other investors continuing in interest are threatened with being taxed on gain, too. Technically the sale of his shares back to the fund is regarded as having been made by an association, and it is regarded as having realized a gain.

If it is regarded as taxable, in fact the bank custodian would have to charge the tax to the accounts of the investors remaining in the periodic payment plan, and not entitled to the gain.

The association tax can be avoided since an election can be filed for the association to have it treated as a regulated investment company, if the gain can be regarded as distributed. A regulated investment company is not taxed on a gain that is distributed. Of course, it is distributed here. That is the whole idea, to pay the liquidating investor's interest to him, so a deduction for distributions paid should be allowed. But the distribution is threatened with being disregarded as if it were not made at all.

In 1963 the distribution was threatened with being disregarded on the ground that it was preferential. It would not have been preferential if the liquidating investor's gain had been disrtbuited pro rata to all the other investors. That was not possible. It would have been criminal, as a matter of fact.

Your committee corrected this by doing away with the preferential rule in the 1964 Revenue Act, and indicating that a liquidating investor's gain should not result in tax to the other investors continuing in the plan.

Now it has lately been indicated that most of the gain attributed to this imaginary association still can be regarded as not distributed. Only a fraction would be regarded as distributed, that is, equal to the fraction which the liquidating investor held of all the mutual fund shares held under the plan by all periodic payment investors.

For example, if he held 1 percent, then only 1 percent of his gain could be regarded as paid out to him even though it all is paid to him. The other 99 percent would remain subject to association tax chargeable to the other investors.

The last investor would be wiped out by taxes on other people's gains. Perhaps worse, if an investor merely withdraws his fund's shares from the custodian bank, he may be regarded as ending an equity interest in an association equivalent to a corporation like ending a stock interest in a real corporation. It might be a technical stock redemption, in other words, and he could have a capital gain to pay tax on even though he would be taking no cash, and his fund's shares still could go up or down in value, and he would be in the same position as any other shareholder of the fund not under a periodic payment plan.

All this can be cured easily by a perfecting amendment not involving revenue loss doing away with the association concept here. Each investor would be regarded as owning his own mutual fund shares with the bank custodian disregarded as merely a nominee or custodian for him. The law could be amended easily in a new section 517 after the other capital gain changes.

We have submitted such an amendment to the Treasury, and Dr. Woodworth's staff, and met no opposition. We have also submitted it to Mr. Tom Vail, chief counsel of your committee. (See p. 4852.)

The CHAIRMAN. May I ask you a question about this, because what you are suggesting is complicated. Our staff says you are probably right about what you are saying. The Treasury proposed to analyze this and give you a letter saying whether they are agreeing or disagreeing. Has Treasury reached a conclusion on this matter yet?

Mr. GOLDMAN. No, sir. There is a draft, and Mr. John Nolan said that he would try to get it out to the Congress so that it could be used one way or another.

The CHAIRMAN. Well, they ought to make up their mind, because they have a lot more people working for them than we have working for us, and if we are going to arrive at a conclusion they ought to be able to. If they cannot arrive at any conclusion, I for one expect to vote with you on this matter, because our best information is that you are right about it.

Mr. GOLDMAN. Sir, I would rather that you had the Treasury's opinion before you——

The CHAIRMAN. I am going to vote to report this bill out October 31 ready or not, and as far as your problem is concerned I will be voting on it at that time. So if they cannot make up their mind by that time as to what their position is I think we will just have to go ahead and take care of it based on our own best advice.

Mr. GOLDMAN. Senator Long, I have come here today and I came here once before purely as a tax technician. When I called several years ago about this problem of Senator Williams', I had occasion to say that I was a tax technician, I was coming here on something on the merits as a technical matter. I told him in fact I was not a professional lobbyist. I said I did not own a loud-checked suit or a Derby hat or smoke a cigar. Senator Williams said that was not required uniform for lobbyists anymore.

I would like to say in conclusion the amendment is only a perfecting amendment. It is simple and involves no revenue loss. It really is badly needed, and it will help large numbers of very little people—up to 2 million families. I would like to thank you very much.

The CHAIRMAN. Since you brought the subject up, on the 4th of July in Louisiana, at least on every second year the legislature is in session, they usually take time off to have a little fun. One year when I was there, they decided on the 4th to legislate on a bill to regulate lobbyists, to require that they wear a special uniform, and also to require that they contribute something to the legislator's entertainment fund, and arrange for both the meeting place and the refreshments so that the legislators could meet with the lobbyists and do their business in the open, where everybody would know about it.

We need people like you to come in here and explain to us some of the very difficult technical parts of this thing and how it will affect your clients. Thank you very much for this. It is very complicated, but we do hope to arrive at the proper conclusions.

Mr. GOLDMAN. Thank you very much.

(Richard L. Goldman's prepared statement with a suggested amendment follows:)

STATEMENT OF RICHARD L. GOLDMAN, TAX COUNSEL ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.

SUMMARY

A proposed Sec. 517 is needed in the Tax Reform Bill, after "other changes in capital gain treatment".

It is needed to avoid threat of two capital gain taxes on one gain, and perhaps one tax on no gain. It is a perfecting amendment, involving no revenue loss.

It would protect small and unsophisticated investors who accumulate mutual fund shares under a perodic payment plan (by which they may invest, for example, $25 a month for a period of years).

When one investor liquidates his interest under the plan (his shares being sold back to the issuing fund by the bank custodian to give him his cash), his gain is taxed to him, as is proper. But it may be taxed a second time because the investors are considered an "association" equal to a corporation for tax purposes and the "association" is regarding as having sold the fund shares and realized a gain. The association, electing to be a "regulated investment company", should not be taxable on the gain because it is distributed. But the gain is threatened with being treated *as if* not distributed, for techical tax reasons. The second tax would be borne in effect by the other, continuing investors not interested in the gain. A prior threat of double tax was done away with in 1964, and Congress indicated that one person's liquidating gain should not be taxed to others.

In another instance, there could be a gain tax on no gain at all.

The perfecting amendment would abolish "association" status for such investors. They are unrelated and the action of one should not affect the tax status of the rest.

STATEMENT

Introduction

Mr. Chairman, and distinguished members of the Committee, I appreciate the privilege of making this Statement to you.

I am Richard L. Goldman. I am tax counsel to the Association of Mutual Fund Plan Sponsors, Inc. The Assoication is an organization of mutual fund underwriters which sponsor periodic-payment plans for the accumulation of mutual fund shares. Under each plan, investors make monthly payments to accumulate shares of a designated fund. Typically, an investor may pay $25 a month for 10 years. The payments are made to a bank custodian, which buys shares of the issuing fund from the fund and holds them for the respective accounts of the investors.

There are nearly 2,000,000 such investors. Usually, they are small investors and unsophisticated ones.

Need for corrective amendment

A perfecting amendment is needed because these investors are threatened with *two capital gain taxes on one gain*—one of the taxes being levied, still more remarkably, on investors other than the one who is entitled to the gain—and, conceivably, they are threatened with *one gainst tax on no gain at all.*

In a tax reform bill, there should be room to reform such a situation. A draft of amendment is submitted with this Statement.

No revenue loss

No revenue loss would result, and no opposition has been encountered. We have submitted the draft of amendment to the Treasury, and to Dr. Woodworth and his staff. There has been some study by each office, and we have responded to questions.

Nature of the investors' tax trap: "association" status

At present, periodic-payment investors, though unrelated and having nothing in common, are lumped together for tax purposes as an "association" equivalent to a corporation, required to file corporate returns and subjected to certain corporate rules. The corporate rules are inappropriate, when applied here, and can lead to unbelievably wrong results. This is so even though "regulated investment company" treatment is elected and should avoid such results.

For example, suppose that an investor wishes to liquidate his interest under the periodic-payment plan. Let us assume his fund shares have a cost of $2,000 and present value of $5,000. He terminates his periodic-payment program, ordering the bank custodian to sell his shares back to the fund and distribute the proceeds to him including his gain of $3,000. He is taxable on the gain, of course, and rightly so. But the "association", regarded as acting through the bank, has sold the shares technically realizing a gain to it of $3,000. Tax on the gain at the association level can be avoided, under the so-called "pass-through" treatment allowed to a regulated investment company, but only if the gain is honored as having been distributed. This is because a regulated investment company gets a deduction for distributions paid (Code Sec. 852(b)(3)) so as to be taxed only on gains which are not distributed. Unfortunately, our "association" may not get this deduction even though the gain actually is distributed.

This would leave the gain subject to tax, not only to the liquidating investor, but again at the association level to be borne by the other, continuing investors who are not entitled to his gain.

Thus in 1964, it was suggested that the gain could not be regarded as distributed—that is, the deduction would not be allowable to the association—because the distribution, though actually made, was "preferential" unless made pro rata to all the investors under the periodic-payment plan including those not entitled to the gain. It may be explained that the deduction itself was conceived originally for "personal holding company" purposes, and for those purposes was not to be allowed if made "preferentially" to one shareholder instead of all. (Secs. 561, 562.) But these rules have been extended into the regulated investment company area, to afford pass-through treatment. As extended into this area, they work imperfectly. It seemed to do no good to suggest to the Service that one person's gain could not be divided among the others as well, and that the others had no gains which could be the subject to a pro rata distribution to them, too. This, as just stated, threatened to leave the liquidating investor's gain taxable also to the other, non-liquidating investors.

That view seemed senseless. Indeed, the last investor would have lost his entire investment through taxes on other people's gains.

Fortunately, the Revenue Act of 1964—by action initiated by this Committee—corrected the situation by adding to the Code Section 852(d), which provides against disregarding a distribution as "preferential" where an investor is liquidating his interest under a periodic-payment plan.

The same problem has cropped up again, in another form. It has been indicated, at the Internal Revenue Service, that the distribution to the liquidating investor still may be disregarded, in spite of the 1964 legislative record reflecting, in so many words, Congress' intention that a liquidating investor's gain is not to be taxed to the continuing investors too.

The theory now suggested is that if the liquidating investor owns, for example, 1% of all the fund shares held under the periodic-payment plan, then only 1% of his gain could be regarded as distributed to him because (likening his case to that in a real corporation) there is a sort of redemption of his equity interest in the "association" and, under rules applicable to real corporations, when a corporation redeems a fraction of its outstanding stock only the same fraction of its profits can be regarded as distributed. The balance remains on the books, for tax purposes, so as to give rise to dividend treatment upon future distribution. This would mean, where periodic-payment investors in a mutual fund are imagined to be an "association", that 99% of the liquidating investor's gain would be regarded as undistributed—leaving that 99% subject to tax at the association level as well as to the liquidating investor, but this time to be borne by the other investors.[1]

Thirdly, it has been suggested that an investor merely withdrawing the fund shares credited to his account—that is, terminating his periodic-payment pro-

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[1] 1% of the *dividends* received during the year by the "association" would have to be regarded as distributed to the liquidating investor, too. He would still get only capital gain treatment, under the analogy to corporate stock-redemption rules. But this would mean that although 100% of dividends received by the bank custodian are distributed to the periodic-payment investors, as required under the plan, the imaginary association would be regarded as having a lesser amount in profits—so that the excess of dividends over profits would have to be treated as a return of capital, avoiding dividend tax.

gram and taking out his fund shares in kind—would be terminating a sort of "stock" interest in the association, this time for a distribution in kind, but nevertheless equivalent to a stock redemption by a real corporation. Under stock redemption rules (Code Sec. 302), that would mean that he would be taxed on the value of his fund shares in excess of his cost basis—on the appreciation in the shares he would be withdrawing—even though he would merely be in the same position as shareholders directly holding shares in the fund. He would not have cashed in his investment, which might fall in value (or rise further), yet he would be regarded as if he had closed out his investment and be taxed.

Such threatened tax treatments do not comport with economic reality; or with the public's understanding; or with a sensible reading of the Internal Revenue Code in light of Congress' underlying policies. They make no sense, in short.

Solution afforded by the proposed amendment

These problems arise repeatedly. They arise because of flaws in the law, as administered, growing out of the imagined assumption that total strangers have been "associating" with each other like people who knowingly invest in a real industrial corporation.

Our amendment would do away with "association" treatment: the corporate rules would not apply.

Instead, each investor would be regarded as owning his fund shares directly, through the bank custodian as a mere nominee. It would be the same as if the shares were held by a brokerage house in "street name", for the investor as real owner.

This would simplify the tax law, and—

(1) save the investors from threat of unintended double taxes on capital gains, or single taxes on no gains;

(2) save the Service from having to administer a technical maze of rules producing no revenue; and

(3) conform the tax law to reality as the public knows it, and to the policy intended by Congress.

Why unrelated investors are treated as an "association"

The technical reason for treating periodic-payment investors as an "association" equivalent to a corporation is that the bank, serving as custodian as required under SEC rules, is regarded as if it were a central management like the President and Board of Directors of a real corporation.

In fact, the bank custodian does not manage at all. The fund is specified in the prospectus of the periodic-payment plan as the investment medium and it cannot be changed except, under SEC rules, in an emergency.[2]

Investors not to be re-classified after the amendment as some other entity, such as "trust" or "partnership"

The proposed amendment would, if adopted, prevent any imaginary form from being imputed to the periodic-payment investors. No association or corporate form would be imagined, as already discussed. Also, there would be no "partnership" or "trust".

This is because our hope is to have done with this imaginary-entity problem once and for all. We do not want to have to come back and bother this Committee a third time, having been here in 1963–64 and again now.

Also, in a very few cases the investors seem to be regarded as a large group "trust". The Service view is that an investor liquidating his interest in such a group trust can have a deductible loss even if he merely withdraws his fund shares.[3] This implies a threat that he could have a taxable gain by merely withdrawing the fund shares, even though he would not really be ending his investment.

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[2] Such as failure of the mutual fund, or its ceasing to offer shares. No change to a new fund could be made for an investor if he objected.

The sponsor company (that is, the underwriter distributing shares of the fund under the periodic-payment plan) contracts to make the fund's shares continually available. If it fails to act, the bank has to step in. The bank serves as a watchdog for investors presumed to be unable to act readily for themselves. The bank would have to find another sponsor company or itself act as sponsor; or if the fund shares were no longer available to be purchased, it would select a different fund—giving the investor notice and an opportunity to object. An objection would have to be honored.

[3] Rev. Rul. 68–633, 1968–50 I. R. B. 15.

Limited scope of amendment

The amendment is intended only for periodic-payment plans for the purchase of shares of a single mutual fund, not various funds. The amendment would apply if some emergency requires discontinuing purchasing shares of one fund, and switching to another.

But it would not apply to any so-called "fund of funds" in which a portfolio is actively managed, and which is set up on a periodic-payment basis. There has been indication of Treasury concern over this, and of a desire to limit the scope accordingly. (Of course, in our usual case, a single fund is designated in the prospectus and S. E. C. rules would prevent shifting to other funds on an actively managed basis.)[4]

Effective dates

The proposed perfecting amendment should apply in 1969, to do the job best.

No taxable event would result from enactment of the perfecting amendment. Periodic-payment investors would no longer be regarded as in a plan "association" for tax purposes. But there would not be any actual event, of liquidating the "association", so as to give rise to tax.

Place of amendment in the bill

The perfecting amendment could be added as Sec. 517 of the Tax Reform Bill, immediately after "Other Changes in Capital Gain Treatment" (Sec. 516, at page 300).

That positioning would be appropriate, since the corrective effect will be on capital gain treatment.

Text of Amendment

SEC. 517. PERIODIC PAYMENT PLANS TO INVEST IN MUTUAL FUNDS.

(a) Section 852 of the Internal Revenue Code of 1954 (relating to special rules for the income tax treatment of regulated investment companies and their shareholders) is amended by adding at the end thereof the following new subsection:

"(e) For purposes of this title:

"(1) the terms 'corporation,' 'partnership,' and 'trust' shall not be construed to mean or include a unit investment trust (as defined in the Investment Company Act of 1940)—

"(a) which is registered under said Act and issues periodic payment plan certificates (as defined in said Act), and

"(b) substantially all of the assets of which, or of each series of which, consist of securities issued by a management company (as defined in said Act) or issued by a single other corporation;

"(2) notwithstanding that such assets shall be held by and/or registered in the name of (or in the name of a nominee of) a trustee, or custodian, contemplated by section 26(a)(1) of said Act, each holder of an interest in such unit investment trust, to the extent of such interest, shall be regarded as owning such assets directly through such trustee, or custodian, as mere nominee acting on behalf of such holder;

"(3) the basis of such assets to such holder shall be the same as that of such interest; and

"(4) in determining the period for which such holder has held such assets, there shall be included the period for which he held such interest if such assets have the same basis, in whole or in part, in his hands as such interest under paragraph (3) of this subsection."

(b) *Effective Date.* The amendments made by subsection (a) shall apply with respect to taxable years of such unit investment trust ending after December 31, 1968 and with respect to taxable years of such holder in which such ending date shall be included. No taxable event shall be deemed to result from such application.

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[4] Similarly, the amendment should not apply where the investment medium of the periodic-payment plan is a managed portfolio of industrial stocks. A few mutual funds are set up on this basis, rather than as a corporation, and there is no occasion to change their tax treatment.

However, there are a few plans for the accumulation of shares of a designated industrial corporation, specified in the governing prospectus. (Sponsors of such plans are not members of our Association.) Covering those plans in this amendment appears appropriate, and has, therefore, been provided.

MEMORANDUM

PROPOSED TECHNICAL TAX AMENDMENT: FOR THE RELIEF OF INVESTORS ACCUMULATING MUTUAL FUND SHARES THROUGH PERIODIC PAYMENT PLANS

This memorandum has to do with adding to the tax reform bill a technical tax amendment relating to mutual funds. I have discussed the amendment with (1) Mr. John Nolan of the Treasury who has said he would give a favorable report; (2) Dr. Laurence N. Woodworth and several of his Joint Committee staff, who I understand to be preparing a report; and (3) Mr. Thomas Vail of the Finance Committee staff.

The amendment, which would stop unrelated people from being treated as an "association" required to file corporate returns and be subject to certain corporate tax rules, is purely technical.

No revenue loss is involved.[1] The amendment would simplify the tax law and conform it to the understanding of the public.

The intention is to enable people who invest in mutual fund shares to be treated taxwise in the same way, even if they do not merely buy shares in the usual way but under a program of periodic payments (for example, $25 a month for 10 years) to a custodian bank which, as required by the S.E.C. buys the shares and holds them for the investors' respective accounts. A maze of complex tax rules prevents giving such uniform treatment to periodic payment plan investors now.

The Internal Revenue Service treats the people accumulating shares of one or another mutual fund through a periodic payment program as an "association" equivalent to a corporation. The technical reason is that the bank custodian serves as a central entity analogized to a corporation's management, even though in fact the bank is a mere title-holding entity for investors who really are not in any sort of joint venture and generally are unaware that they are treated as if they were, for tax purposes.

Our draft of amendment (attached hereto) would do away with "association" status for tax purposes here, so that people investing in a designated fund under a periodic payment program[2] would be treated in the same way, taxwise, as people buying shares of that fund by the more traditional means of making a single payment. Each person would be regarded, as a result of the amendment, as owning the fund shares credited to his account, with the bank custodian being disregarded as a mere nominee (like a stockbroker who holds shares "in street name" for his customer).

This would eliminate filing corporate returns for the aggregated, but unrelated, investors as an "association" and would eliminate applying inappropriate corporate-tax rules.

No revenue would be lost because even today, as indicated above, the association can elect to be treated as a "regulated investment company" and obtain tax exemption for dividends and capital gains received from the plan's designated mutual fund and passed through to the investors.[3]

But our amendment would correct a situation in which pass-through treatment is threatened constantly by the application of technical rules by the Internal Revenue Service in a manner inconsistent with Congress' basic policy against extracting a corporate tax from investment income when the investors are earning the income through a mutual fund. Not a year goes by without threat of technical use of the tax rules in such a wrongful way. Thus, for example:

1. A prior amendment enacted in 1964 at our request (adding Sec. 852(d) to the Code) was needed because the Service threatened to extract *two* capital gain

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[1] The "associations" can opt to be treated as regulated investment companies, which means that dividends and gains have to be distributed currently but then are not taxed to the association—if, but only if, the rules are applied properly.

[2] Only the shares of *one* fund—the one designated in the periodic payment plan certificate and the prospectus—are purchased for all the investors under any particular "periodic payment plan". No change can be made except in case of emergency and indeed the custodian bank has no discretionary function except in an emergency. Use of a bank is required under S.E.C. rules precisely for emergency protection of periodic payment plan investors, usually small investors.

[3] Periodic payment plan investors may be classed, rarely, as a group "trust" not subject to corporate tax rules, hence free of corporate or other tax at the trust level. (Our amendment would do away with the trust (or partnership) characterization too, in order by eliminating fictitious-entity concepts to let the investor be taxed entirely as owner of his fund shares.)

taxes on each capital gain of an investor liquidating his interest. Thus, he would instruct the bank custodian to sell the fund shares credited to his account back to the issuing fund and distribute the cash to him including, of course, any gain. Any gain would be taxed to him, quite properly, just as if he owned the shares outright. But the Service, looking at the *remaining* investors under the periodic payment program for the same fund as an "association", indicated that the gain would be subject also to a capital gain tax payable by the "association", for the remaining investors, even though they were not entitled to any portion of the gain of the departing investor who had liquidated his interest. The indication was that the gain would not be regarded as distributed by the "association", avoiding tax at that level, because (under Secs. 561 and 562 of the Code) it was a "preferential" distribution, not having been made ratably to all the investors including those not entitled to it. We suggested that the public could hardly stand a 50% extraction of taxes from capital gains in such circumstances, and the law was amended in the Revenue Act of 1964 so as to provide that the distribution of such gains should not be disregarded by being called "preferential".

In other words, we thought that this reaffirmation of Congress' "pass-through" policy, of not taxing the liquidating investor's gain except to himself, had corrected the situation. More recently, however, conversations with the Service staff have revealed that even that amendment did not do the job. The reason offered was that when an investor liquidates his periodic payment plan investment, amounting (for example) to 1% of all the fund shares held by investors under that plan (the bank custodian selling his shares to the fund and remitting the proceeds including gain to him), only the same fraction—only 1%, in the example—of the gain could be charged off as distributed on the "association's" corporate tax return, saving tax on the gain at that level to that extent. The other 99% of the gain, *though in fact distributed,* would be treated as not distributed—with resultant failure of "pass-through", hence leaving the gain taxable a second time at the "association" level. The technical theory for this was that when a conventional corporation (such as AT&T) redeems a fraction—say, 1%—of its outstanding shares, only the same fraction of the earnings and profits can be regarded as distributed. The evidently inappropriate application of this theory to a pass-through situation would leave the second tax, payable with the "association's" return, to be borne in effect by all the other—the continuing—investors even though they would not be entitled to any of the gain belonging to, and paid out in fact to, the liquidating investor.

2. As another example, it has been suggested that an investor would be taxed on the appreciation in his fund shares if he were merely to withdraw the shares from his custodian bank. Of course, in such a case he would simply be putting himself in the same position as people already owning their fund shares directly, rather than having them held by a custodian bank by reason of the periodic payment plan. He would not be ending his investment, and so it is too soon to mark gain or loss, recognizable for tax purposes. Nevertheless, the theory has been suggested that technically the withdrawal would constitute the "association's" corporate-type redemption of the individual's equity in the association, generating tax to him on the appreciation in his fund shares even though he would not be cashing in his investment. Yet to treat the situation like redemption of stock of a real corporation would not comport with economic reality; or with the understanding of the public itself; or with Congress' policy to avoid double taxes where people invest through a mutual fund.

These are only examples. Other problems, too, have confused the administration of the tax laws and threatened to give rise to tax solely because of flaws in the law growing out of the imagined assumption that total strangers are "associating" like people who knowingly form conventional corporations.

Our proposal, that "corporation" treatment not extend to investors accumulating shares of a mutual fund under a periodic payment program, but that instead they be regarded as owning directly the shares credited to their accounts, will avoid the recurrent problems.

It will save the investors from threat of unintended double taxes on capital gains. It will save the Service from administering a technical maze of rules producing no revenue. And it will conform the tax law to reality as the public understands it, and to serve the policy which Congress always intended.

TEXT OF AMENDMENT

A BILL Relating to the income tax treatment of certain regulated investment companies and their shareholders

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

SEC. 1.—PERIODIC PAYMENT PLANS TO INVEST IN MUTUAL FUNDS.—

(a) Section 852 of the Internal Revenue Code of 1954 (relating to special rules for the income tax treatment of regulated investment companies and their shareholders) is amended by adding at the end thereof the following new subsection:

"(e) For purposes of this title:

"(1) the terms 'corporation,' 'partnership,' and 'trust' shall not be construed to mean or include a unit investment trust (as defined in the Investment Company Act of 1940)—

"(a) which is registered under said Act and issues periodic payment plan certificates (as defined in said Act), and

"(b) substantially all of the assets of which, or of each series of which, consist of securities issued by a management company (as defined in said Act) or issued by a single other corporation;

"(2) notwithstanding that such assets shall be held by and/or registered in the name of (or in the name of a nominee of) a trustee, or custodian, contemplated by section 26(a)(1) of said Act, each holder of an interest in such unit investment trust, to the extent of such interest, shall be regarded as owning such assets directly through such trustee, or custodian, as mere nominee acting on behalf of such holder;

"(3) the basis of such assets to such holder shall be the same as that of such interest; and

"(4) in determining the period for which such holder has held such assets, there shall be included the period for which he held such interest if such assets have the same basis, in whole or in part, in his hands as such interest under paragraph (3) of this subsection."

SEC. 2.—EFFECTIVE DATE.—

The amendments made by Section 1 shall apply with respect to taxable years of such unit investment trust ending after December 31, 1968 and with respect to taxable years of such holder in which such ending date shall be included.

The CHAIRMAN. The next witness is Dr. Norman Topping, president of the University of Southern California on behalf of California Independent Colleges.

Is Dr. Topping here?

Senator Murphy is very anxious that we hear from him.

[No response.]

The CHAIRMAN. We will call the next witness. That would be Mr. John Rinaldo of Rinaldo & Associates, Long Beach, Calif.

May I advise the other witnesses that after we hear from Mr. Rinaldo we will quit until 2 o'clock and the other witnesses will be heard starting at 2 o'clock. They can make their plans accordingly.

STATEMENT OF JOHN RINALDO, REPRESENTING RINALDO & ASSOCIATES, LONG BEACH, CALIF.

Mr. RINALDO. Mr. Chairman, Senator Hansen, I would like to express my gratitude for the privilege of testifying before you today. I am a preparer of tax returns for middle-income taxpayers. My average client or 50 percent of my clients have adjusted gross incomes less than $10,000. Seventy-five percent of them have incomes less than $15,000. Last year we prepared close to 10,000 income tax returns.

Every year we are used to hearing the outcry in regards to the problems of Federal income taxation, the problems of complexity of their tax returns, and certain inequities in the tax law, and last year, last spring I think it kind of reached a crescendo, and I think this crescendo of taxpayer malcontent I think was heard at Capitol Hill, too.

I think that this is one of the reasons for the tax reform bill as I understand it as a layman.

The problem with the new tax bill seems to be that it is a very complex bill. I have been here all morning and have listened to much expert testimony, and most of the testimony has indicated that the bill is extremely complex. I have done some analysis of how it would affect my clients, and have found that the one provision which is section 801, is the provision that would provide for some simplicity in the preparation of their tax returns.

However, the middle-income taxpayer will receive very little benefit or at least my clients will receive very little benefit from section 801. There would only be a crossover of roughly 11 percent of my taxpayers who file itemized deductions who would then use the standard deduction.

Therefore, I feel that you may consider the fact that the bill, even for those who probably need it the most, is going to provide so little simplicity in the preparation of their tax returns. As a matter of fact, I think that there is testimony here today that would indicate even the middle-income taxpayer is going to be faced with more complex tasks in preparing his tax returns. He too has capital gains. He too, especially in my area in Long Beach, has oil royalties. He, too, frequently has a small-income unit behind his own residence where he may be depreciating a dwelling that he rents to his tenants, so I believe that the law will provide some complexity for the middle-income taxpayer.

I feel that there will be very little simplification in the preparation of his return, and I therefore have made a suggestion that in lieu of simplifying his tax return you might consider the inclusion of section 804, which allows a limited amount of tax relief in a reduction of tax rates.

The CHAIRMAN. I think you have a good idea, and we do appreciate your statistical analysis. You tell me that very few clients would be benefited by this bill based on your study?

Mr. RINALDO. I believe that the middle-income taxpayer will receive very little benefit. He will receive very little benefit as far as simplicity is concerned, and as far as tax relief is concerned, if there is any question about this, I believe he is going to wind up paying more taxes.

The CHAIRMAN. Thank you very much, sir.

Mr. RINALDO. Thank you.

(Mr. Rinaldo's prepared statement follows:)

STATEMENT OF JOHN RINALDO, LONG BEACH, CALIF.

Our firm prepares tax returns for 10,000 middle income taxpayers per year. Based on the proposed 1969 Tax Reform Bill (HR 13270) our clients would receive only a very limited tax relief by the increase in the standard deduction. Further using the statistics available through the Internal Revenue Service the average taxpayer who itemized deductions would receive no benefit, in either simplicity of filing or in reduction of taxes.

DESCRIPTION OF STATISTICAL TECHNIQUES USED

Using an IBM 1130 computer all data on all our clients was analyzed according to the effect of the adoption of the proposed standard deduction. Our clients are divided according to adjusted gross income as follows:

	Percent		Percent
0 to $1,000	0.5	$13,000 to $14,000	5.6
$1,000 to $2,000	2.0	$14,000 to $15,000	7.5
$2,000 to $3,000	3.4	$15,000 to $16,000	1.5
$3,000 to $4,000	3.0	$16,000 to $17,000	2.8
$4,000 to $5,000	4.7	$17,000 to $18,000	3.9
$5,000 to $6,000	8.1	$18,000 to $19,000	3.5
$6,000 to $7,000	8.5	$19,000 to $20,000	3.0
$7,000 to $8,000	9.1	$20,000 to $21,000	1.5
$8,000 to $9,000	5.6	$21,000 to $22,000	0.5
$9,000 to $10,000	4.3	$22,000 to $23,000	1.2
$10,000 to $11,000	5.0	$23,000 to $24,000	1.2
$11,000 to $12,000	5.3	$24,000 plus	2.1
$12,000 to $13,000	5.8		

Data cards for all clients were analyzed to determine the number of clients who used the percentage standard deduction in 1969. This represented 7.2% of all clients. Using the same data cards from 1969 we analyzed the number of clients who would have used a 13% (1400.-maximum) standard deduction. The percentage thus using the standard deduction increased from 7.2% to 9.0%. Using the same method we determined the percentage of clients who would use the 14% ($1700.-maximum) standard deduction. The percentage thus using the standard deduction would be 11.7%. Finally we analyzed the number of clients who would have used the 15% ($2000.-) standard deduction. The resultant percentage was 18.2%. According to our data there would be a cross over of 11% of our clients from itemized deductions to the new 15% standard deduction, all other data remaining constant.

Using the same data cards we then computed the total income tax, before credits and surtax, paid by all our clients in 1969. This total tax figure was $9.578,280.- We then proposed the same question allowing for the 15% ($2000.) standard deduction where such deduction would be greater than that used in 1969. In other words projected the tax revenue from our clients for 1972 under section 801: HR 13270. The total revenue. before credits and surtax, would be $9,480,180. The difference would represent less than one percent tax reduction for our total clients. It should further be noted that the treasury statistics based on adjusted gross income broken down into categories as follows $5–6M; $6–7M: $7–8M; $8–9M; $9–10M; $10–15M; $15–20M; $20–50M; and $50–100M all had average itemized deductions greater than 15%.

Therefore we recommend to the Committee that the tax rates for individuals Sec. 804 be retained in order that the middle income tax payer receive some limited tax relief from the 1969 Tax Reform Law.

STATEMENT OF THOMAS G. WALTERS, PRESIDENT, NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES

Mr. Walters. Could I just file a statement. It is a very short statement. I would like permission to make a part of the record a letter addressed to you by one of your constituents, Matt Creed, which in a very few words sums up the position of the National Association of Retired Civil Employees even better than I could sum it up.

The Chairman. Might I see the letter?

Senator Hansen. Mr. Chairman, who is our witness?

Mr. Walters. Thomas G. Walters, president of the National Association of Retired Civil Employees.

The CHAIRMAN. We will print your statement in the record, Mr. Walters, and I want to see the letter from Mr. Creed. I know him personally and have a high regard for what he says.

Mr. WALTERS. Briefly, Mr. Chairman, we represent only the retired people, Senator Hansen, of the Federal Government. We think an across-the-board tax exemption for these people, especially those in low-income brackets, would be much better than any complicated method, and that is the gist of my statement that is printed on page 377 of the printed report. We feel that these people are—and I know that you are going to give them serious consideration to try to do something for the low-income people who are being hit very hard by the high cost of living, and of course one other thing we mentioned in here is the amendments to medicare, which would permit the payment of prescription drugs that is not now covered, and that is something that needs to be done very badly.

The CHAIRMAN. May I say that I find Mr. Creed's letter especially appealing, and I am certainly going to see that it is printed in the record for obvious reasons. If Senator Hansen will look at the last paragraph you will see why.

He is a very fine man.

Mr. WALTERS. He is not only a fine man in my opinion; he is a well-versed man and a man with a lot of knowledge and knowhow. That has been my observation, and I am sure the same with yourself.

Senator HANSEN. Mr. Walters, if I may, let me say that the respect that is evidenced in the letter that you show me here from Mr. Creed goes far beyond the borders of the State of Louisiana. The distinguished chairman of this committee has a very dedicated following in my State of Wyoming.

Mr. WALTERS. I think that is true all over the country.

Senator HANSEN. I am sure it is.

Mr. WALTERS. And that is one reason I wanted this letter in the record, because I knew the Senator would not put it in the record unless somebody else did, but I wanted to see it in there. Thank you very kindly.

The CHAIRMAN. Thank you so much.

(Thomas G. Walters' prepared statement and the letter referred to follow:)

MATT H. CREED REALTY, INC.,
Hammond, La., September 13, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Old Senate Office Building, Washington, D.C.

MY DEAR SENATOR LONG: After reading the Congressional Record of September 4th, pages S10143 and S10144, I want to let you know that I greatly appreciate your interest in the membership of the National Association of Retired Civil Employees.

Senator, wouldn't it be easier for our people to understand and make out their tax returns if they had across the Board tax exemption? NARCE resolutions from time to time have asked for a $5,000 tax exemption.

According to the latest statistics issued by the Civil Service Commission, there were only 986 annuitants on the annuity rolls receiving $1,000 and over per month, and that 548,819 annuitants were receiving less than $500 a month; and 249,965 survivor annuitants receiving less than $300 a month; and that 191,232 annuitants were receiving less than $150 per month; and 209,574 survivor annuitants receiving less than $150 per month.

As an old friend of yours, and one that retired after 37½ years of honorable Civil Service, I request that you give serious consideration of across the Board exemption, with proper dividing lines, to eliminate the inequity you listed in the Congressional Record of September 4th.

Many old annuitants like myself have to work at other jobs to pay for medicine and living costs that continues to go up.

As I travel the state of Louisiana, I run into many of yours and my old friends, and often we speak of you. Like myself, as voters we believe in you. As an annuitant and an old friend of yours, I am asking you to do something for us. NARCE has nine Chapters in Louisiana as well as a State Federation of Chapters. I want to be able to tell these Old Folks that you are still working for them.

With kindest personal regards and thanks for your concern for us, I am

Sincerely yours,

MATT H. CREED.

P.S.—I am still a Realtor in order to supplement my annuity.

STATEMENT OF THOMAS G. WALTERS, PRESIDENT, NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES

SUMMARY

The National Association of Retired Civil Employees, of which Thomas G. Walters is President, is a 48-year old non-profit and incorporated organization whose 135,000 plus members are retirees of the United States Government Civil Service.

The Committee is urged to consider, in its deliberations on tax treatment of the elderly, the following items:

Exemption of the elderly from any surcharge tax.

Exclusion from the gross income of the first $5000 for a family and the first $3600 for a single person received as Civil Service annuity from the United States Government or any agency thereof.

Re-establishment of the provision to deduct drug and medical expenses for persons 65 years and older. (Deleted in 1967). S. 1564 introduced by former Senator Everett McKinley Dirksen and now before this committee provides for this restoration for income tax purposes.

Amendment of Medicare to provide for the payment of prescription drugs outside-of-hospital.

Amendment of Medicare to provide that provisions (a) and (b) be made available to all Federal annuitants and their survivors.

STATEMENT

Mr. Chairman and Members of the Committee, my name is Thomas G. Walters, President of the National Association of Retired Civil Employees (NARCE). This organization was formed February 19, 1921, and has been in continuous operation since that date. We now have over 135,000 members with more than 1100 chapters in every State in the Union, Puerto Rico, Canal Zone, and the Philippines. Our membership is made up exclusively of retirees from the Federal Government and their survivors, and I appear this morning on behalf of our membership plus all other Civil Service annuitants and their dependents in the interest of tax reforms which relate to the treatment of these retired people.

As near as humanly possible, equalization of tax benefits has been the goal of our organization for many years, and I congratulate you, Mr. Chairman, and your committee, for your desire to bring about tax reforms and equalize the tax burden. I am happy that these hearings are being held and that representatives of NARCE are permitted the privilege of appearing before this committee to present the views of our members. We strongly believe that some sectors of our economy can help, but we believe that the elderly should be exempt from any surcharge tax and that taxes should be based on ability to pay.

The members of the House and Senate, especially the members of the House Ways and Means Committee and Senate Finance Committee, are to be congratulated for giving serious consideration to a tax reform bill. We sincerely appreciate the attempt by the House Ways and Means Committee and the membership of the House in endeavoring to make beneficial changes, but we strongly believe that an across-the-board exemption would be more easily understood and would make filing of income tax reports much simpler than any other method of tax relief, especially for the older person.

In the 91st Congress many bills have been introduced to grant across-the-board tax exemptions, and we are firmly convinced that a resolution unanimously adopted at our National Convention in San Francisco, California, in 1968, endorsing the exemption of the first $5000 of Civil Service annuity from Federal income tax was a good one.

Our Association believes that a retiree's family should have a Federal tax exemption of $5000, and a single retiree a tax exemption of $3600. As we grow older, we require more medical attention, more drugs and hospitalization, and with the ever increasing cost of living and maintaining a home, in our opinion the figures of $5000 and $3600 are not unreasonable. Much has been said in the press and by public officials that a family living on less than $3000 per year is living in poverty.

Most annuitants and their survivors are in the low income bracket. According to the latest statistics issued by the United States Civil Service Commission only 986 annuitants receive a monthly annuity of $1000 or more. 281,435 annuitants received less than $200 per month and 231,958 survivor annuitants received less than $200 per month. 110,436 annuitants received less than $100 per month; and 168,288 survivor annuitants received less than $100 per month.

Mr. Chairman and Members of the Committee, we receive hundreds of letters and we are convinced that we are not asking for anything unreasonable when we ask for a tax exemption under Federal Income Tax for retirees in the amount of $5000 for a family and $3600 for a single individual. Because of age and infirmities most of our members find it impossible to secure supplementary employment and to put it bluntly, at the age of most of our retirees, due to mental and physical deterioration many must be placed in nursing homes for which most of the health benefits programs are very limited in their coverage. We can furnish you with hundreds of names and addresses, but for the record I am quoting from two letters that came in the mail to NARCE recently:

"My husband's annuity is $264 a month and he is 88 years old and I am 82, and due to his mental condition, the doctors have placed him in a nursing home, and the $264 per month nothing like covers the cost". This letter from Alabama.

From the State of Colorado: "With 15 years of service . . ." this lady receives "$107 per month."

It is generally understood that drug and hospital expense for those over age 65 are, on the average, three times higher than those for all Americans, and approximately one-half of all Americans over age 65 are living at or near the poverty line. We have hundreds of cases of members writing us that though they can see the doctor, they can not afford to have their prescriptions filled. To aid these low income retirees, we are urging early consideration of a measure to have prescription drugs covered by Medicare.

With all of our members being retired Federal employees or survivors, we also meet with the problem that many of them are not eligible for Part A or the Hospitalization portion of Medicare. We should greatly appreciate seeing the Medicare law amended so that all persons over 65 would be eligible for both portions of Medicare coverage. I would be happy to furnish any additional information along this line that you desire.

We realize that you have a most complex problem in attempting to bring forth legislation to equalize the great tax burden of this country, but we do feel that the younger people and those that have their life before them, and the larger companies and individuals with tremendous salaries should bear the greater burden of the taxes and make it as light as possible for the senior citizens who have over the years worked hard and paid all taxes required of them. I believe most people are of the opinion that the people of this country who work for a reasonable or small salary, pay a greater percentage of the taxes than any other group. The retirees of the Federal Government paid taxes on their salaries during their working careers and we strongly recommend that we now have some tax relief. We believe that if we had a $5000 tax exemption for a family and $3600 for a single individual it would be a step in the right direction.

Until 1967 we were able to deduct our drug and medical expenses provided we were 65 years of age. We strongly recommend that this provision be re-established as this would mean a great deal to all senior citizens. S. 1564 introduced by the late Senator Dirksen, and referred to this Committee would achieve this.

Mr. Chairman and Members of the Committee, we would like very much to summarize our suggestions as follows:

Exemption of the elderly from any surcharge tax.

Exclusion from the gross income of the first $5000 for a family and the first $3600 for a single person received as Civil Service annuity from the United States Government or any agency thereof.

Re-establishment of the provision to deduct drug and medical expenses for persons 65 years and older. (Deleted in 1967). S. 1564 introduced by former Senator Everett McKinley Dirksen and now before this committee provides for this restoration for income tax purposes.

Amendment of Medicare to provide for the payment of prescription drugs outside-of-hospital.

Amendment of Medicare to provide that provisions (a) and (b) be made available to all Federal annuitants and their survivors.

Thanks so much, Mr. Chairman, for giving us the privilege and opportunity of appearing before your Committee.

The CHAIRMAN. Perhaps it would be well to include also at this point in the Record, a letter expressing concern over the exclusion of foreign service retirees, and statements that have been submitted by the Government Employees Council of the AFL-CIO and the National Conference of Public Employee Retirement Systems.

(The letter and statements referred to follow:)

CHEVY CHASE, MD., *September 12, 1969.*

Hon. J. WILLIAM FULBRIGHT,
U.S. Senate,
Washington, D.C.

MY DEAR SENATOR FULBRIGHT: Reference is made to HR 13270, known as The Tax Reform Act of 1969, which passed the House of Representatives and is now before the Senate Finance Committee.

It appears that this bill will be of very little help to middle income taxpayers—a class into which I, a Foreign Service retiree, falls—and that this help will be delayed until 1971.

It is my understanding that the National Association of Retired Civil Employees will present to the Senate Finance Committee a proposal that the first $5,000 of *Civil Service Annuity* not be counted as income for Federal tax purposes.

This proposal does NOT include *Foreign Service Retirees.* It is, therefore, requested that appropriate steps be taken to give similar exemptions to Foreign Service retirees.

Your assistance in this matter will be greatly appreciated.

Sincerely yours,

(MISS) NONA L. GARDINER.

STATEMENT OF THE NATIONAL CONFERENCE OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS

The National Conference of Public Employee Retirement Systems represents about 200 organizations including state, school, and municipal public employee retirement systems, and their affiliated organizations. The total number of individual members of organizations represented by the Conference is approximately 4,000,000.

This statement is limited primarily to the tax treatment of retired persons.

The Conference urges the enactment of S. 2968, introduced by Senator Ribicoff, *at this session of the Congress*, either as a separate amendment to Section 37 of the *Internal Revenue Code* or as a part of the Tax Reform bill.

GENERAL COMMENTS

As members of this Committee are well aware, our organizations have long supported equitable tax treatment for the retired. In 1953 many of the organizations we represent supported an exemption of up to $1,500 of retirement income.[1]

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[1] H.R. 5180 introduced by Representative Noah Mason in the 1st session of the 83rd Congress and referred to the Committee on Ways and Means.

Instead of an exemption, the Retirement Income Tax Credit was enacted in 1954. We supported this change to the Retirement Income Tax Credit and have often worked for its improvement. The Credit has not been improved since 1962, and we note with regret no proposal to improve it is included in H.R. 13270, the Tax Reform bill.

The purpose of the Retirement Income Tax Credit is to provide tax equity to those public employees who are not covered by Social Security, but only by their local or state public employee retirement systems. Employees under Social Security pay no taxes on Social Security benefits. Public employees pay taxes on benefits from their retirement systems. It is this inequity among retired persons the Retirement Income Tax Credit is designed to reduce or eliminate.

A large number of the public employees we represent—such as firefighters, policemen, and a substantial number of teachers—are not covered by Social Security. It is estimated that about 400,000 to 500,000 retired public employees presently use the Retirement Income Tax Credit.

At present, the Tax Credit is 15% of $1524, with reductions for earned income and any Social Security benefits received.

The base figure ($1524) is the key to maintaining equity. If it is set at the average maximum payable under Social Security each year, the result will be that those who may use the Tax credit will receive about the same tax treatment as those who receive tax-free Social Security benefits.

At present, this base figure is too low, having last been increased in 1962. The base should be increased to at least $1,872 to be equal to the average maximum payable under Social Security.

RECOMMENDATIONS

Retirement Income Tax Credit

The $1524 base of the Retirement Credit should be increased to at least $1,872 (as proposed in S. 2968), effective for the 1969 tax year. Since the Credit has been falling behind Social Security maximums for seven years, there is an urgent need to effect the increase now. Many of those we represent have already paid more in taxes the last few years than they should have. To delay further compounds the inequity.

S. 2968 also increases the earnings limit to assist those older citizens who must supplement their retirement income with modest earnings. The Conference strongly supports this increase.

Other Tax Reform Proposals

The Conference is aware that many of the provisions of the present tax reform bill will be helpful to many of our members. The low-income allowance and the increase in the standard deduction will be beneficial to many who are retired on low incomes. The new Intermediate Tax Rate will apply to many of our retired members since a large percentage of them are single, or widows and widowers.

CONCLUSION

In conclusion, we urge the Congress to up date the Retirement Income Tax Credit by enacting S. 2968, amending Section 37 of the *Internal* Revenue Code. We respectfully point out that this proposal is not a new provision of the tax law, but is one which has been been on the books since 1954. The proposal is intended only to make the Tax Credit provision do that which was intended to do: provide equity among retired persons.

Submitted for the Conference by,

JACK E. KENNEDY,

President and Executive Secretary of the Colorado Public Employees Retirement System.

GOVERNMENT EMPLOYES COUNCIL—AFL–CIO,

Washington, D.C., July 15, 1969.

STATEMENT OF THE GOVERNMENT EMPLOYES COUNCIL, AFL–CIO

The Government Employes Council and its 34 member AFL–CIO unions, which represent more than 1 million classified, postal and wage board Federal employes

desires to express its appreciation to you and your colleagues for arranging this series of hearings on a subject of vital concern to every citizen of our country.

For some years, the Council has advocated removal of income taxes on civil service annuities.

There is pending before this Committee S-422 by Senator Joseph M. Montoya, which would accomplish this objective in part. We recommend sympathetic consideration by the committee.

Recipients of pensions under the Railroad and Social Security Acts are relieved of payment of income tax on these benefits. The exemption was included specifically in the railroad retirement system when that statute was enacted in the 1920s. Application by the Internal Revenue Service of a Supreme Court decision to the social security law in the 1930s resulted in the income tax exclusion on these benefits.

Underlying these actions was the valid premise that income taxes should be based on "ability to pay." We submit, Mr. Chairman, that this rationale applies today with equal logic to the pensions of retired Federal workers.

Of the 581,000 civil service annuitants, 41,000 (7%) have monthly benefits below $50. There are 250,000 survivor annuitants. One quarter receive less than $50 monthly.

The number of retirees receiving less than $100 monthly is 110,000 (18%). Payments below $100 are made to 168,000 (67%) survivors.

Put another way, almost half the individuals on the retirement rolls are entitled to payments of less than $100.[1]

Certainly, the conclusion is justified that these men and women have a very limited "ability to pay" under the philosophy of our income tax statute.

The Labor Department's Bureau of Labor Statistics periodically publishes a "Retired Couple's Budget for a Moderate Living Standard."

The study based on Autumn, 1966, figures (Bulletin No. 1570-4) revealed a husband age 65 or over and his wife, who are self-supporting and live independently, required $3,869 to maintain a decent level of living. The range varied from $4,434 in Honolulu to $3,236 in smaller cities in the South.

Updated to June, 1968, the overall figure moved to $4,049.

We do not maintain that each and every civil service annuitant and survivor must receive monthly payments to meet this precise figure. But BLS finding does indicate clearly the inadequacy of benefits paid to almost half the present civil service retirement beneficiaries and their consequent inability to pay income taxes without sacrificing essential needs.

In a restricted sense, Congress recognized the limited "ability to pay" of these individuals some years ago by approving a retirement income credit for Civil Service annuitants equal to the lowest tax rate on $1,200. Currently, the credit is approximately $1,524.

For these reasons, Mr. Chairman, the Council recommends that the Committee approve removal of the Federal income tax on civil service pensions.

The CHAIRMAN. Mr. Sadler?

STATEMENT OF CARL K. SADLER, LEGISLATIVE DIRECTOR, AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES; ACCOMPANIED BY STEPHEN A. KOCZAK, DIRECTOR OF RESEARCH; AND JAMES H. LYNCH, JR., ASSISTANT LEGISLATIVE REPRESENTATIVE, AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES (AFL-CIO)

Mr. SADLER. I am Carl Sadler, legislative director scheduled to appear this afternoon. I wonder if I, too, could not submit my statement for the record?

The CHAIRMAN. We will be glad to print your statement. We will have it printed and if you want to briefly tell us about your statement we will hear you right now.

[1] Source—U.S. Civil Service Commission Annual Report on Civil Service Retirement for the fiscal year ended June 30, 1967.

Mr. SADLER. I will take just 1 minute, if I may.

Certainly, I agree with Mr. Walters. Our approach is much the same. We would just say that we think that the retirees of the Federal Government should be accorded the same benefits as those under Social Security and those under the Railroad Retirement System who pay no tax on their annuities, and we would hope that this committee would give consideration to making their annuities tax-exempt as well.

The CHAIRMAN. Thank you very much.

(Carl K. Sadler's prepared statement follows:)

STATEMENT SUBMITTED BY CARL K. SADLER, LEGISLATIVE DIRECTOR, AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES

THE EXEMPTION FROM INCOME TAX OF CIVIL SERVICE ANNUITIES

In the name of the American Federation of Government Employees, I wish to express gratitude to the distinguished Chairman of the Senate Committee on Finance and to its other members for this opportunity to testify on the important subject of tax reform as it affects Federal employees.

Our organization which now has more than 320,000 dues-paying members and which represents more than 560,000 Federal employees in exclusive recognition units, is composed, of course, of taxpayers. Every one of our members has the Federal income tax deducted at the time he receives his Federal pay check.

These employees have become increasingly aware that certain major inequities, certain vestiges of serious tax injustice, continue to exist in current tax practices. These injustices exist in our general tax policy; they also exist in specific discrimination and selective injustice suffered by Federal employees, especially in the continuing unfair Federal practice of income taxes levied on their Civil Service annuities.

Your Committee has already received testimony from George Meany, the President of the American Federation of Labor and Congress of Industrial Organizations, regarding certain grave injustices in our general Federal tax policy, especially the failure of the "loophole set", as he described them, to bear their fair share of the tax burden. As a member of the American Federation of Labor and Congress of Industrial Organizations, we endorse the position taken by Mr. Meany and associate ourselves with him. For the sake of brevity, however, I shall not dwell upon or repeat what he has already said and I shall restrict my comments to those matters which he did not touch but which are of especial significance to us.

Tax justice, like every other kind of justice, must be based on the principle that the persons affected will be granted equitable treatment in law and in practice. Whatever the law grants to one class of citizens, the same should be granted, in similar manner, to all comparable classes.

Moreover, tax justice, like every other kind of justice, should reflect the general standards and norms of contemporary society. As we know, in our society it has been accepted that it would be improper to place a heavy taxation burden on persons who are on the fringes of poverty.

Yet I must come before you today to inform you that these noble precepts of our contemporary society are not being carried out in the case of more than 870,000 human beings who were either Federal employees and are now retired or who are the survivors of Federal employees.

Annuitant beneficiaries of the Social Security system, for example, and of the system established by the Railway Retirement Act pay no income tax whatsoever on their annuities. Yet retired Federal employees and their survivors must pay this tax in full on that portion of their annuities which is derived from contributions by their Federal employer.

Our organization favors, of course, the exemptions granted so wisely by our government to pensioners of the Social Security system. When one looks at the amounts of these pensions, it is obvious that this is a humane and just course for our nation to pursue.

Our organization likewise favors and supports the provisions of the Railway Retirement Act. We are gratified that the Congress specifically exempted all income received by these annuitants from income taxation.

We must ask you, however, the following question: Are not annuitants under the Civil Service Retirement system entitled to the same kind of humane and wise consideration from their Congress and from their Federal government as beneficiaries of the Social Security system and the Railway Retirement Act?

In our judgment, the answer is obviously "yes".

Let us look at the facts.

Participation in the Social Security system is mandatory for all categories of persons covered. Participation in the Railway Retirement Act is also mandatory. But so is participation in the Civil Service system.

The Civil Service system, just like the Social Security and the Railway Retirement systems, is a mandatory system. It is not a voluntary system.

Even though the mandatory payroll deductions from earnings in the Civil Service System are technically called "contributions", the fact is that the deductions are mandatory for both the employee and the employer.

If we were to call things by their right name, we must recognize that these "contributions" are in fact a tax. And, as you know, under the terms of another Bill before the Senate, the rate of these mandatory "contributions" might soon be raised from 6.5% respectively by employee and employer to 7.0% each. Therefore, the current total tax of 13.0% of payroll may soon be 14.0%. This compares with a total current tax in the Social Security system of only 9.6% of payroll, shared equally at 4.8% each by employer and employee.

As these facts show, one can really find no meaningful legal distinction between the three systems, Social Security, Railway Retirement and Civil Service so far as mandatory contributions are concerned or the financial sharing of the burden by the employer and employee. Yet, the Civil Service annuitant must pay an income tax on that portion derived from the Federal employer's "contribution".

We believe this is discrimination, discrimination unworthy of our contemporary society with its great emphasis on equal rights.

There are some persons who have been saying that Civil Service annuitants are in such a favorable economic position that they do not need tax justice, that they do not need tax relief.

I wish those people were right.

But they are very, very wrong.

The most recent comprehensive figures, compiled by the Civil Service Commission, show that on June 30, 1968, almost 100,000 Federal employee annuitants and survivor annuitants received less than $50.00 a month in annuities. This is less than $600.00 a year. Moreover, this amount was subject to income tax.

The statistics also show that 276,073 employees annuitants and survivor annuitants received less than $100.00 a month. This is less than $1,200 a year. Moreover, this was subject to income tax.

Almost 400,000 employee and survivor annuitnats received less than $150.00 per month, or less than $1,800.00 per year. This too was subject to income tax.

Of the total number of 871,072 persons on the Civil Service retirement rolls on that date, 514,863 received less than $200.00 per month, or less than $2,400.00 per year. Moreover, the overwhelming number of these persons had wives or other dependents. Yet, the annuities were subject to income tax.

Other people have argued that this is largely the inheritance from the past and that the economic conditions of Federal employees currently entering the annuitant rolls are much better.

Again, I must state that they are very, very wrong. Again, I say, let us look at the facts, let us look at the statistics of those Federal employees and survivors newly added to the annuity rolls in fiscal year 1968.

During the fiscal year 1968, the following persons were added to the rolls:

A.—19,262 widows, with an average age of 61.2 years, who receive an average annuity of $138.00 per month or $1,656.00 per year. On this income, these widows paid an income tax.

B.—10,347 children, with an average age of 14.6 years, who received an average annuity of $50.00 per month, or $600.00 per year. On this income, the parent or guardian had to pay income tax.

C.—52,579 employee annuitants, with an average age of 60.3 years, who received an average annuity of $291.00 a month or $3,492.00 per year. The very great majority of these employee annuitants, totally 35,045, had wives and other dependents. Yet their annuities were subject to income tax. Distinguished members of this Senate Committee, that is the very sad picture of the financial state of affairs of those Federal employees and survivor annuitants who came onto the rolls of the Civil Service annuity system for the first time in fiscal year 1968.

Yet every one of these persons must pay income tax on that portion of his or her retirement income which comes out of funds contributed by the employer.

In my presentation, I have chosen up to now only the most representative statistics in order to illustrate the injustice suffered by Federal annuitants as a class. I could have chosen, of course, large numbers of cases of a far more pathetic and pitiable nature. There are, for example, over 1,000 widows with an average age of 75.2 years who receive a grand total of $51.00 per month, or $612.00 per year. There are, for example, widows over 75 years of age who receive $31.00 per month, or exactly $1.00 per day. Their total annual income is thus $365.000. Yet, this is subject to income tax.

I shall not burden you here with more statistics and examples. Instead, I request your permission to place into the record four tables giving the facts. The first table shows the grand total of all annuitants on the Civil Service retirement rolls as of June 30, 1968, by monthly rates of annuity. The second table shows the total number of survivor annuitants as of that date. The other two tables show the numbers of employee annuitants and survivor annuitants added to the Civil Service retirement roles during the fiscal year ending June 30, 1968.

SUMMARY AND CONCLUSION

A comparison of the Social Security, the Railway Retirement Act and the Civil Service retirement systems shows that, although all are mandatory, the Civil Service employee suffers discrimination because his annuities are subject to income tax payment on income derived from contributions of the Federal employer.

An analysis of the annual income of both the Civil Service employee and survivor annuitants reveals that an overwhelming majority are living at the poverty level. Children are receiving $600.00 per year as total income; some widows, aged 75 and over, are receiving as little as $365.00 annually or one dollar per day. Over 514,000 annuitants receive less than $200.00 per month and many of these must support wives and other dependents.

The precepts of tax justice require that we extend to Civil Service annuitants the same tax policy that now applies to Social Security and Railway Retirement Act annuitants—total exemption from all income tax.

In the name of the American Federation of Government Employees, I again petition you to remove this vestige of tax discrimination which has been endured too long by our retired Federal employees, by their dependents and by their survivors. The great majority of them are now living at or near the poverty level and they are in urgent need of tax relief.

In conclusion, I wish again to express my appreciation for the kind courtesy you have shown to my organization by allowing me to appear before you today and for the thought and deliberation you will be giving to my petition.

Annexes:

Table 1—Number of employee annuitants and survivor annuitants on the retirement roll as of June 30, 1968, by monthly rates of annuity

Table 2—Survivor annuitants on the retirement roll as of June 30, 1968

Table 3—Employee annuitants added to the retirement roll during the fiscal year ended June 30, 1968

Table 4—Survivor annuitants added to the retirement roll during the fiscal year ended June 30, 1968

TABLE 1.—NUMBER OF EMPLOYEE ANNUITANTS AND SURVIVOR ANNUITANTS ON THE RETIREMENT ROLL AS OF JUNE 30, 1968, BY MONTHLY RATES OF ANNUITY

	Employee annuitants			Survivor annuitants			
Monthly rates of annuity	Total	Prior to Public Law 854	Under Public Law 854	Total	Prior to Public Law 854	Under Public Law 854	Under Public Law 85-465
Under $10	170	132	38	785	462	322	1
$10 to $19	3,827	3,417	410	8,775	5,999	2,716	60
$20 to $29	10,923	8,958	1,965	15,865	7,008	8,024	833
$30 to $39	12,606	8,377	4,229	18,006	5,998	10,417	1,591
$40 to $49	10,427	6,482	3,945	18,431	6,470	10,574	1,387
Subtotal—under $50	37,953	27,366	10,587	61,862	25,937	32,053	3,872
$50 to $59	14,222	8,222	6,000	37,414	6,305	29,343	1,766
$60 to $69	12,671	6,548	6,123	27,588	5,124	20,449	2,015
$70 to $79	13,072	5,781	7,291	17,150	5,354	8,893	2,903
$80 to $89	12,793	4,889	7,904	19,401	11,929	7,187	285
$90 to $99	12,930	4,448	8,482	9,017	3,347	5,141	529
Subtotal—under $100	103,641	57,254	46,387	172,432	57,996	103,066	11,370
$100 to $109	14,833	4,652	10,181	11,697	4,957	6,740	
$110 to $119	18,239	4,751	13,488	8,761	3,186	5,575	
$120 to $129	13,393	3,581	9,812	6,929	2,283	4,646	
$130 to $139	16,622	3,509	13,113	10,869	3,119	7,750	
$140 to $149	14,836	2,985	11,851	6,488	2,617	3,871	
Subtotal—under $150	181,564	76,732	104,823	217,176	74,158	131,648	11,370
$150 to $159	16,596	3,247	13,349	6,714	2,709	4,005	
$160 to $169	18,161	3,168	14,993	6,440	2,490	3,950	
$170 to $179	16,934	2,609	14,325	4,022	1,236	2,786	
$180 to $189	18,116	2,407	15,709	4,676	1,555	3,121	
$190 to $199	20,093	2,816	16,277	4,361	1,175	3,186	
Subtotal—under $200	271,464	91,979	179,485	243,389	83,823	148,696	11,370
$200 to $249	91,891	21,810	70,081	12,329	2,851	9,478	
$250 to $299	65,412	13,627	51,785	5,436	1,025	4,411	
$300 to $349	52,249	8,267	43,982	2,641	451	2,190	
$350 to $399	38,338	3,772	34,566	1,439	217	1,218	
$400 to $449	26,167	1,658	24,509	809	66	743	
$450 to $499	17,847	1,007	16,840	466	34	432	
Subtotal—under $500	563,368	142,120	421,248	266,505	87,967	167,168	11,370
$500 to $599	19,630	953	18,677	334	12	322	
$600 to $699	10,065	421	9,644	110	4	106	
$700 to $799	5,427	139	5,288	33	2	31	
$800 to $899	3,030	31	2,999	9		9	
$900 to $999	1,693	11	1,682	7	1	6	
Subtotal—under $1,000	603,213	143,675	459,538	266,998	87,986	167,642	11,370
$1,000 and over	1,660	7	1,653	1		1	
Grand total	604,873	143,682	461,191	266,999	87,986	167,643	11,370

TABLE 2.—SURVIVOR ANNUITANTS ON THE RETIREMENT ROLL AS OF JUNE 30, 1968

Class of survivor annuitant	Number on the roll	Total annuities (monthly) Amount	Total annuities (monthly) Average	Average age in 1968	Average service of deceased (years)
Prior to Public Law 854					
SURVIVORS OF DECEASED ANNUITANTS					
Title dependent on designation by retiring employees:					
Widows	29,307	$3,792,350	$129	73.3	28.3
Widowers	103	8,221	80	76.5	22.5
Children	112	6,347	57	59.9	27.8
Other	148	15,486	105	74.5	31.8
Title not dependent on designation by retiring employees:					
Widows	28,761	1,716,910	60	76.5	22.8
Widowers	578	27,773	48	77.1	19.1
Children:					
Spouse surviving	1,700	48,022	28	22.1	19.1
No spouse surviving	441	20,798	47	34.4	23.1
SURVIVORS OF DECEASED EMPLOYEES					
Widows	22,876	2,113,233	92	67.3	18.6
Children:					
Spouse surviving	3,579	93,860	26	19.3	12.7
No spouse surviving	381	16,892	44	26.5	14.4
Total	87,986	7,859,892	89	69.2	23.0

Public Law 854

SURVIVORS OF DECEASED ANNUITANTS					
Title dependent on designation by retiring employees:					
Widows	59,232	$7,858,358	$133	64.8	23.4
Widowers	1,317	113,600	86	63.5	17.9
Children	32	2,477	77	48.7	22.3
Other	144	18,452	128	68.1	29.1
Title not dependent on designation by retiring employees:					
Children:					
Spouse surviving	11,876	623,840	53	15.6	17.6
No spouse surviving	1,169	78,240	67	18.6	17.1
SURVIVORS OF DECEASED EMPLOYEES					
Widows	52,527	6,633,374	126	56.7	19.8
Widowers	109	8,667	80	67.3	16.6
Children:					
Spouse surviving	38,564	1,986,661	52	14.5	16.8
No spouse surviving	2,673	172,540	65	15.6	13.7
Total	167,643	17,496,209	104	46.1	20.1

Public Law 85–465

SURVIVORS OF DECEASED ANNUITANTS					
Widows	4,202	$259,533	$62	80.7	
Widowers	4	188	47	83.7	
SURVIVORS OF DECEASED EMPLOYEES					
Widows	7,160	391,071	55	75.6	
Widowers	4	179	45	78.2	
Total	11,370	650,971	57	77.5	

Grand total

SUMMARY BY RELATIONSHIP					
Widows	204,065	$22,764,829	$112	66.6	[1] 22.5
Widowers	2,115	158,628	75	68.1	[1] 18.4
Children	60,527	3,049,677	50	15.7	16.7
Under age 18	44,923	2,231,146	50	13.2	16.0
Students	12,948	679,781	53	19.7	18.1
Disabled	2,512	129,926	52	36.1	22.0
Designated	144	8,824	61	57.4	26.6
Other	292	33,938	116	71.3	30.5
Grand total	266,999	26,007,072	97	55.1	[1] 21.1

[1] Excludes survivor annuitants under Public Law 85–465, effective Aug. 1, 1958.

TABLE 3.—EMPLOYEE ANNUITANTS ADDED TO THE RETIREMENT ROLL DURING THE FISCAL YEAR ENDED JUNE 30, 1968

RETIRED UNDER PROVISIONS IN EFFECT PRIOR TO AMENDMENTS BY PUBLIC LAW 854

Provisions under which retired	Number added to the roll			Total annuities (monthly)		Type of annuity			Average survivor annuity (monthly)	Average contributions	Average age in 1968	Average service (years)	Number with Federal employees group insurance
	Total	Men	Women	Amount	Average	Life only	Life, plus survivor annuity: Widows or widowers	Life, plus survivor annuity: Other					
Disability	7	4	3	$576	$82	7				$1,378	53.9	10.6	1
Optional, 15–29 years' service, age 62	2	2		126	63	1	1		$31		79.0	18.5	
5 years' service, immediate annuity	7	5	2	248	35	7				59	86.6	9.4	
5 years' service, deferred annuity	2,626	1,740	886	142,237	54	2,626				1,416	63.6	11.8	
Involuntary, 25 years' service	2	2		225	113	2				1,579	64.5	27.5	
Members of Congress	2	2		349	175	1	1		76	7,700	63.0	7.0	
Transferred from other systems	11	10	1	579	53	11				2,843	62.6	11.3	
Total	2,657	1,765	892	144,340	54	2,655	2		54	1,422	63.7	11.6	1

RETIRED UNDER PROVISIONS AS AMENDED BY PUBLIC LAW 854

Provisions under which retired	Total	Men	Women	Amount	Average	Life only	Widows or widowers	Other	Average survivor annuity (monthly)	Average contributions	Average age in 1968	Average service (years)	Number with Federal employees group insurance
Mandatory, 15 years' service, age 62	75	18	7	$11,032	$441	9	16		$277	$10,024	62.9	26.8	24
Mandatory, 15 years' service, age 70	3,006	2,006	940	918,472	306	1,815	1,779	12	190	6,895	71.0	25.5	2,862
Disability	15,087	11,397	3,690	3,535,451	234	3,965	11,122		117	4,994	53.4	18.7	12,929
Optional, 30 years' service, age 55	5,697	4,932	765	2,700,537	474	1,127	4,558	12	268	8,921	57.6	32.9	5,503
Optional, 30 years' service, age 60	5,169	4,362	807	2,641,606	511	1,108	4,043	18	299	9,307	64.4	35.5	6,972
Optional, 20–29 years' service, ages 60 and 61	4,153	2,803	1,350	1,263,786	304	1,430	2,715	8	175	7,286	61.3	84.8	3,895
Optional, 12–29 years' service, age 62	11,163	7,002	4,161	2,748,202	246	4,322	6,815	26	146	6,321	65.8	21.7	10,548
Optional, 15–29 years' service, age 62	1	1		50	50		1		27	230	77.0	15.0	
Optional, 20 years' service, age 50	507	498	9	270,664	534	34	472	1	301	10,936	56.5	22.8	500
5 years' service, immediate annuity	878	515	363	67,996	77	327	551		46	2,867	66.4	8.8	134
5 years' service, deferred annuity	1,423	699	754	175,166	123	565	854	4	72	3,275	62.9	14.5	
Involuntary, 20 years' service, age 50	1,064	766	298	259,892	244	281	782	1	136	6,232	55.2	22.4	954
Involuntary, 25 years' service	1,743	1,395	348	570,664	327	411	1,330	2	184	7,751	52.7	26.9	1,667
Members of Congress	6	5	1	4,463	744	1	5		467	22,442	61.2	15.7	2
Total	49,922	36,429	13,493	15,167,961	304	14,795	35,043	84	175	6,592	60.1	23.8	43,980
Grand total	52,579	38,194	14,385	15,312,301	291	17,450	35,045	84	175	6,330	60.3	23.2	43,981

SURVIVOR ANNUITANTS ADDED TO THE RETIREMENT ROLL DURING THE FISCAL YEAR ENDED JUNE 30, 1968

Class of survivor annuitant	Number added to the roll	Total annuities (monthly) Amount	Total annuities (monthly) Average	Average age in 1968	Average service of deceased (years)
PRIOR TO PUBLIC LAW 854					
Survivors of deceased annuitants:					
Title dependent on designation by retiring employees:					
Widows	1,903	$255,961	$135	73.0	29.6
Widowers	8	713	89	79.2	26.4
Children					
Other	7	562	80	76.0	26.7
Title not dependent on designation by retiring employees:					
Widows	1,066	54,458	51	75.2	21.2
Widowers	41	1,922	47	78.0	18.9
Children:					
Spouse surviving	117	3,182	27	18.2	19.6
No spouse surviving	33	1,504	46	35.0	23.5
Survivors of deceased employees:					
Widows:					
With children					
Without children	33	1,407	43	53.5	11.9
Children:					
Spouse surviving	2	24	12	29.0	6.0
No spouse surviving					
Total	3,210	319,733	100	71.2	26.0
PUBLIC LAW 854					
Survivors of deceased annuitants:					
Title dependent on designation by retiring employees:					
Widows	10,532	1,516,262	144	63.2	23.9
Widowers	418	37,724	90	61.6	18.1
Children	3	189	63	39.7	24.7
Other	16	2,690	168	66.3	31.5
Title not dependent o designation by retiring employees:					
Children:					
Spouse surviving	2,774	144,680	52	15.5	19.0
No spouse surviving	246	16,447	67	18.1	18.7
Survivors of deceased employees:					
Widows:					
With children	2,792	379,760	136	43.1	13.2
Without children	2,904	440,062	152	55.8	21.4
Widowers	12	831	69	63.8	15.3
Children:					
Spouse surviving	6,693	328,317	49	13.9	18.1
No spouse surviving	479	29,844	62	14.2	14.1
Total	26,869	2,896,806	108	42.1	20.9
PUBLIC LAW 85-465					
Survivors of deceased annuitants:					
Widows	12	506	42	75.2	
Widowers					
Survivors of deceased employees:					
Widows	20	615	31	75.1	
Widowers					
Total	32	1,121	35	75.2	
GRAND TOTAL					
Summary by relationship:					
Widows	19,262	2,649,031	138	61.2	[1] 23.2
Widowers	479	41,190	86	63.3	[1] 18.3
Children	10,347	524,187	50	14.6	18.2
Other	23	3,262	141	69.3	30.0
Grand total	30,111	3,217,660	107	45.2	[1] 21.4

[1] Excludes survivor annuitants under Public Law 85-465, effective Aug. 1, 1958.

The CHAIRMAN. If there is someone else who will not be able to attend this afternoon we will hear them right now. (No response.)

The CHAIRMAN. All right. We will start at 2 o'clock this afternoon. Thank you very much.

(Whereupon, at 12:20 p.m. the committee recessed, to reconvene at 2 p.m. on the same day.)

AFTERNOON SESSION

Senator TALMADGE. The committee will please come to order.

The next witness is Mr. Ernest Giddings, special legislative representative, American Association of Retired Persons, National Retired Teachers Association.

Will you please come around, Mr. Giddings. I hope you will understand the Senate is in session. We have two bells. That was a quorum call. If it is one, we have to go to the Senate and vote. We have your full statement in the record of these proceedings, so if you would summarize your statement and make it as brief as you possibly can, it would be greatly to the credit of the committee.

STATEMENT OF ERNEST GIDDINGS, SPECIAL LEGISLATIVE REPRESENTATIVE, AMERICAN ASSOCIATION OF RETIRED PERSONS, NATIONAL RETIRED TEACHERS ASSOCIATION; ACCOMPANIED BY JACK BOSTICK, CHAIRMAN, LEGISLATIVE COMMITTEE, INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS; AND PETER W. HUGHES, LEGISLATIVE REPRESENTATIVE, NATIONAL RETIRED TEACHERS ASSOCIATION, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. GIDDINGS. Thank you, Senator.

Mr. Chairman, my name is Ernest Giddings. I am the legislative representative of the National Retired Teachers Association, and the American Association of Retired Persons.

Our organization has a membership of about 1,800,000 persons. Accompanying me on my left is Mr. Peter Hughes, also legislative representative of our association, and on my right is Mr. Jack Bostick of Fort Worth, Tex., who is vice president of the International Association of Fire Fighters. Mr. Bostick and myself are members of the Legislative Committee of the National Conference on Public Employee Retirement Systems.

The National Conference consists of about 100 different organizations of retired or active public employees, firemen, police, teachers, and municipal employees, civil service employees, and so forth.

On this I am speaking for our own association and the National Conference.

When your committee in 1954 enacted section 37 of the retirement income credit section of the revenue code, you removed an outstanding inequity in the tax treatment between social security and railroad retirement, which is tax exempt, and the nonexempt retirement income. Then you updated it in 1962 by amending section 37, and by doing that, you again preserved the principle of equal tax treatment of various forms of retirement income.

Since this issue has not been before your committee in 6 years, I will just make a few comments about the early history of this section of the tax code. In 1964 the retirement income credit was passed by the Congress, and at that time it was done in order to remove the discrimination which existed in the tax law between persons who were under social security or railroad retirement, and those who were receiving other forms of nonexempt retirement income.

In view of that situation, the committee at that time pointed out that they were justified in passing the retirement income credit, and it has been updated. It was updated in 1962, as I mentioned. Now, the forms of retirement income, as you know, are pensions, that is public and private pensions, and annuities, interest, rent, and dividends.

When the retirement income credit base was updated in 1962, it was increased from the $1,200 base to the present $1,524 base. That is the base upon which the credit is computed, at the lowest bracket rate. The figure $1.524 at that time was computed, recommended to your committee by the staff of the Joint Committee on Internal Revenue taxation.

Since 1962, some increases in social security benefits have been made, the principal one of course being the 13-percent increase in 1967. But since 1962, no increase has been made in the base on which the retirement income credit is computed.

To again equalize the retirement income credit, then with social security benefits, these are the changes that should be made. First, the amount on which the retirement income credit is computed should be increased from $1,524 to $1,872. If you had acted last year or the year before, this is the figure that you probably would have written into the law to replace the $1.524 figure, because it represents the maximum primary benefit now available under the social security program to any individual.

Of course, to determine the credit the $1,872 is multiplied by the lowest bracket rate. If it were 15 percent, that would amount to a maximum credit of $280.80 per person as contrasted to the $228.10 under the law as it is at the present time. This would make a tax credit then of $52.70.

If and when this is done, an increase presumably would be made also in the reduction due to earned income, and that reduction is described on page 4 of my testimony in this way. The reduction made in the retirement income credit on account of earned income should be changed to correspond with the changes made in the earned income reduction provided in the social security law.

Thus, while under the present law, earnings between $1,200 and $1,700 a year reduce the tax credit by $1 or $2 earned, under a really conforming amendment, earnings between $1,680 and $2,880 reduces the tax credit, by that same formula, that is $1 for every $2 earned.

The bill introduced by Senator Abraham Ribicoff on September 29 is a bill which will restore the tax equity that I am talking about, and restore the tax equity to those persons who depend upon public pensions or other forms of retirement income in lieu of social security or railroad retirement. That bill is designed to remove the discrimination, then, which has arisen gradually in the 6-year period as changes have been made in the social security program. In that time no improvement has been made by the Congress in the retirement income credit.

Now, S. 2968 introduced by Senator Ribicoff does no more and no less than to again adjust counterpart section 37 provisions to conform with existing social security laws. It would increase the retirement income ceiling from the present $1,524 to $1,872, thus conforming it with the present social security primary benefit ceiling.

In the most extreme case, the increase in benefit to one individual would be $52.70. Generally, however, it would not amount to that much, and a fair estimate we believe is that it might over all of the taxpayers affected amount to possibly half that figure.

The other point to be made in that connection is that it seems to us as it did 6 years ago that the retirement income credit is certain to affect fewer people as the years go along.

In summary, I would point out that while the dollar benefit in the Senator's bill is important to every retired person, the prinicpal of tax equity under the tax laws of the Nation is of equal importance, and the passage of that bill will again reassure retired persons that they will not be discriminated against by the tax-writing committees of the Congress.

Our association and the conference urges your committee to write the Ribicoff amendment into the tax reform bill.

Now, I would like to comment on three other items, and in speaking on these, I am speaking only for my own organizations the National Retired Teachers Association and the American Association of Retired Persons.

One is the full medical and drug deductibility. Mr. Chairman. we hope the committee will take action this year to restore the right of every person over age 65 to take the full Federal income tax deduction on his unreimbursable medical and drug costs.

As long as the medicare program contains the present exclusions. deductibles and co-insurance provisions, the several million taxpayers over age 65 should have this protection, we believe. This point is not included in the House bill.

The other point I would call to your attention is the exclusion of low-income older people from income tax liability. It has been our belief that there is a block of older people who should be granted this protection, this benefit, and my association went on record a year ago recommending that single persons over age 65 with incomes up to $3,500 a year, and married couples over 65 with incomes up to $6,000 a year, should be exempt from paying a Federal income tax.

By the way, that point that I have just mentioned is in substance, but to a lesser degree in the House-passed bill.

The other point I wish to comment on is the expansion of the head-of-household tax treatment. Widows, widowers, and unmarried individuals who do not support dependents in a household cannot qualify for head-of-household treatment under the present law. The House-passed Tax Reform Act does provide a substantial improvement in the tax treatment of these people, and it is our hope that your committee will adopt the House-passed provisions or something equally protective to older people. This provision is in the House bill.

That concludes my statement.

Senator McCARTHY. Thank you very much. Do you have any questions, Senator?

Senator FANNIN. No, Mr. Chairman.

You have certainly made an impressive statement. I was not here for the full time, but I will carefully read your statement. I was just wondering if we do have the information as to what the cost would be if this were approved.

Mr. GIDDINGS. It is probable that people in the Treasury would come up with a figure. I just checked the committee report that was made in 1962 under the chairmanship of Senator Byrd, and at that time, the comparable increase was made from a $1,200 base to a $1,524 base, and the committee report at that time said that the estimate was that the loss of revenue might be about $30 million.

Our estimate at that time was a somewhat lesser figure than that, but that was the figure in the report.

Senator FANNIN. On that amount, but you don't have an estimate of the figure, what would be involved in your recommendation of $1,524 to $1,872.

Mr. GIDDINGS. No. Well, the point I was making is that I assume that the Treasury might say that it would be a comparable figure, because the updating we are recommending is from $1,524 up to $1,872 which is quite similar in amount to the adjustment you made in 1962.

Senator FANNIN. A comparable increase.

Senator MCCARTHY. From $1,524?

Mr. GIDDINGS Yes.

Senator MCCARTHY. Roughly, the same amount.

Mr. GIDDINGS. About the same amount.

Senator FANNIN. Mr. Chairman, I have just been informed that it might cost as much as $160 million.

Mr. GIDDINGS. I have not seen any figures that were anywhere near that level.

Senator FANNIN. We can obtain that information.

Mr. GIDDINGS. Yes.

Senator FANNIN. Thank you very much.

Senator MCCARTHY. Everybody has to have his own statistician today.

Thank you very much.

Senator RIBICOFF. You are trying to put yourself on the same equality as social security beneficiaries, is that right?

Mr. GIDDINGS. That is right.

Senator RIBICOFF. And the people that you represent, schoolteachers, firemen, policemen, public employees, have had separate retirement systems apart from social security; is that correct?

Mr. GIDDINGS. That is right.

Senator RIBICOFF. Under social security, and what do you find the lot to be of the retired teacher, policemen and firemen today, in view of the inflationary pressures?

Mr. GIDDINGS. They are suffering considerably from increased prices and from inflation generally, and for that reason we believe that the people who have established their own retirement systems which is not in this case tax-exempt, should be granted this benefit.

Senator RIBICOFF. In other words what you are trying to do, you want to put yourself exactly on the basis of equality with social security retirees?

Mr. GIDDINGS. That is right. That was the basis on which the legislation was passed originally, and the basis on which we believe this adjustment should be made.

Senator RIBICOFF. Thank you very much.

Senator MCCARTHY. Thank you, Mr. Giddings.

The next scheduled witness is Miss Vivien Kellems of East Haddam, Conn.

STATEMENT OF MISS VIVIEN KELLEMS, EAST HADDAM, CONN.

Miss KELLEMS. I am not quite sure of the procedure, Senator McCarthy, I have here thousands of names on petitions that have come from all over the country. I don't know if I may submit these to the committee. How is this handled?

Senator MCCARTHY. We will make them a part of the file, but not a part of the record. You may present them.

(The petitions referred to were made a part of the official files of the committee.)

Miss KELLEMS. If you don't mind, I am going to sit on a book. I am so short I get an inferiority complex.

Senator MCCARTHY. There is something to be said for that. Is that book all right?

Senator RIBICOFF. Of course, Senator McCarthy, I get a great charge out of your being so solicitous of Miss Kellems.

Senator MCCARTHY. All short people.

Senator RIBICOFF. All I can tell you, when it comes to speaking to a group, to a committee, or on radio or television, she has no peer, and I don't think Vivien Kellems needs any lessons on how to address anybody, especially U.S. Senators.

Senator MCCARTHY. I think that Congressional Record volume improves on the World Almanac. Most short people have an advantage when they sit down to those microphones compared to those who are tall. We are glad to have you.

Miss KELLEMS. Thank you. I do better on my feet, but the microphones are so low, and if you knew how nervous I was, Senator Ribicoff, you would not make such a statement.

Senator RIBICOFF. Nobody can speak for Vivien Kellems.

Senator MCCARTHY. You should formally identify yourself for the record.

Miss KELLEMS. I am Vivien Kellems from East Haddam, Conn., and I wish to testify in support of Senate bill 2794, which would remove the penalty tax on single people.

The income tax is like a pregnancy. They both start small but soon swell to alarming proportions. Eventually they both must terminate. We are just about ready for that terminal "happening" now. Ever since Joseph sold the Egyptians into slavery with their own money, the unbridled, uncontrolled income tax has ruined every country that has adopted it. Because of it, England is down the drain and we are just a couple of laps behind.

The income tax is the one basic cause of inflation. The higher the tax the greater the inflation. Reduce taxes and prices will automatically follow.

The first income tax passed under the 16th amendment in 1913 contained 40 pages. The latest published in 1968 is 1,593 pages, and I show it to you gentlemen because I think very often an actual exhibit is better than to just state how many pages it is. Its titles, sub-titles, texts, tables, cross-references, special rules, miscellaneous information, all in very fine print is one vast labyrinth of gobbledegook. Can any brilliant lawyer, can any accountant, can any of you gentlemen on the committee possibly grasp the monstrosity of this tax?

And this does not include court decisions, regulations, special rulings and other paraphernalia.

The Congress now proposes to reform this hydra-headed monster and add 400 pages more. When it is finished, the whole mess is going to be more incomprehensible and hopeless than it is now. Naturally, the whole thing is shot through with favoritism, injustice and inequities.

The most blatant and unconstitutional of them all is the penalty against single people.

There is no law that says single people must pay higher income taxes just because they are single. Congress never has passed such a law, and I very much doubt that Congress would pass such a law. The Supreme Court would have to declare it unconstitutional.

Then how is it possible that over the past 21 years the Federal Government has sucked into its cavernous maw billions of dollars from American citizens on the pretext that it is legal to penalize people for not being married?

It was done in 1948 with a slight-of-hand trick called the community property law, which was not a community property law at all. This was the excuse given for the wholesale robbery of millions of helpless people.

Now to thoroughly understand this law, a short history should be given of it, but unfortunately it is not possible to do this and stay within the 10-minute limit, and I am a garrulous old woman once I get started, so if you wish to give a history of it or to describe it, you could ask me afterwards, but I will leave it out of this testimony, but it should be made quite clear that this was not a community property law.

Not one property law or any other law was changed one iota. Not one piece of property or penny of income changed hands under this law. No wife anywhere received one thing except as she benefited by the tax savings. Everything remained precisely as it was, and the husband still owned his income. It was a straight tax gimmick, class legislation and discrimination of the most flagrant sort.

There was absolutely no pretense. It was a rich, married taxpayer's bill, the higher the income the greater the percentage of saving. Poor married couples, those receiving $5,000 or lower, didn't save a dime. The single taxpayers were left holding the bag. They had to pay at the confiscatory rates of World War II without a penny of relief. Never has a law been passed saying they must pay at these exorbitant rates, but under this so-called community property law, the Internal Revenue Service has arrogated to itself the power to illegally collect billions and billions of dollars from these helpless people.

But more than this, the law gave the rich, married people in the community property States something they had not had before, and this is not generally known. Under this law passed in 1948, these married people could now split all income, including that derived from premarital estates.

If I might diverge for a minute, I could explain. Take a case like Doris Duke, who had an income of $3 million. Had she lived in California and married a man who was making, let's say, $50,000, they could split the $50,000 before the passage of the law in 1948. But under this law in 1948, they could now split the entire $3,050,000. Then on top of this was passed the estate law, which taxed the whole estate of single people but only half of the estate of married people.

Then, finally, to finish it off, before the sad demise of the individual single taxpayer, there was one more indignity, the surtax. Since there wasn't anything more to tax Congress decided to tax a tax. This was not a tax on income, this was a tax on the income tax, and again the single people had to bear the brunt of it.

Ten percent for married people, but up and up and up for single people, because they have to pay 10 percent on the penalty they are already paying. In thousands of cases this runs to 14 percent. I make no comment on this action. The facts speak for themselves.

Has there ever been such rank, discriminatory, unjust, unconstitutional legislation against millions of American citizens? Why? Because they are not married.

There has been one attempt to test the constitutionality of this system. It was the famous *Faraco* case. Mr. Faraco died just before or just after Christmas in 1953, and his widow's tax went up to 40 percent. She brought suit in the Fourth District Court of Richmond, Va., and the judge in this case came through with what I consider the most idiotic decision in the whole legal history of the United States.

He said that because the amount of the penalty tax, 40 percent incidentally, was so slight, it did not violate any constitutional principle. I am not here to pass upon the qualifications of any man for the Federal Supreme Court, but that judge has recently been nominated to serve on that Court.

In 1962, Senator Eugene McCarthy of Minnesota introduced a bill, S. 35, which would permit certain persons 35 years of age or over to qualify as head of household, and pay a lower tax, however, not as low as married persons in the same income tax brackets. There was already a rather nebulous classification, head of household, which Congress had added in 1951, to partly still the cries of outrage from indignant taxpayers, but the requirements were so strict that very few people could qualify. For all the relief it afforded, it might as well not have been there.

Senator McCarthy sought to amplify this classification to include many more overburdened single taxpayers. He got exactly nowhere. His was a lone voice crying in the wilderness. In spite of the lack of understanding and cooperation, even ridicule, the Senator persisted and has reintroduced this bill in each succeeding Congress—88th, 89th, 90th.

Convinced of the injustice of the penalty tax and also persuaded that it was unconstitutional, Senator McCarthy felt that it was the best bill that could be considered at that time, since there was such opposition to the whole idea of fairness and justice for single people. Later other Senators joined him in sponsoring the bill and several

Congressmen have introduced similar bills in the House of Representatives.

As a matter of fact, the administration has come now with their testimony recommending such a bill, and they bring up the question of age 35, which I shall not go into unless Senator McCarthy would give me permission to say why he chose age 35.

Senator McCarthy. I have raised that level a bit since.

Miss Kellems. Well, then, it doesn't apply.

Senator McCarthy. That is right.

Miss Kellems. May I say what you told me?

Senator McCarthy. You may, yes.

Miss Kellems. Senator McCarthy told me that he selected age 35 because a woman was supposed to be most beautiful at age 35.

Senator McCarthy. Melina Mecouri said that. I did not say it. I was just quoting her.

Senator Curtis. I can't let the record stand there.

Senator McCarthy. I understand she has raised the level 5 years since then.

Miss Kellems. I wish it was up to 73, but it isn't.

Senator Curtis. I must dissent from the acting chairman's statement. All the women I know get more beautiful every year.

Miss Kellems. Oh, Senator Curtis, I do hope you will vote for my bill.

Senator McCarthy. I think he is committed now.

Miss Kellems. I should say that I am sorry Senator Long is not here, because when Senator McCarthy introduced this bill in 1962, Senator Long asked him, "Are you trying to give a consolation prize to all these girls because they can't get proposals from a good man?"

And I would have like to ask Senator Long today, doesn't he think it is only right that if a woman can't get a proposal from a good man, that she should be given a consolation prize.

Senator Curtis. Maybe she has one already.

Miss Kellems. Well, I asked the Secretary of the Treasury how many eligible men of 73 or thereabouts he knew, but he did not reply to my question.

Finally, Senator McCarthy stood on the floor of the Senate on August 7 this year, and introduced a bill, S. 2794, to abolish the whole unsavory, unconstitutional mess. He was heartily commended by Senator Ribicoff, of Connecticut, who pledged his support of the bill. Senator Ribicoff said, "The Senator from Minnesota has been in the forefront of this fight for many, many years. He has been a lone voice, receiving very little support from anyone else in the executive branch or in the legislative branch. I will certainly be pleased, as a member of the Committee on Finance, to support the Senator's efforts to bring justice in this important field."

It is this bill, gentlemen, which brings me before your committee today.

On April 15, I signed a blank income tax form 1040 and sent it to the Director of Internal Revenue, Andover, Mass. I then wrote the Secretary of the Treasury that I would not pay any more taxes until the Federal Government refunded to me the sum of $73,409.03, taxes which have been illegally collected from me for the past 20 years, plus interest.

From that time, letters have poured in from all over the United States. As their numbers increase, my blood pressure rises. They come from all over the country, from all kinds of people, young people working their way through college, elderly widows trying to make ends meet on meager incomes, school teachers, nurses, telephone operators, stenographers, secretaries, factory workers, and thousands of retired people—a cross-section of America. All tell one bitter, heartbreaking story, a crushing penalty tax by an all-powerful, greedy, ruthless government for one reason only, these millions of people are not married.

What began as a simple test of the constitutionality of this tax, has now become a flaming, emotion-packed crusade.

We are creating paupers out of decent, self-respecting, self-supporting American citizens. Read these letters and see if you can stay calm; widows with small children, women whose husbands have been killed in Vietnam and who must pay a penalty for the sacrifice they have made, other widows using the capital of the small estate left by a husband to pay current taxes; one woman living on crackers and tea.

And this woman inclosed a dollar bill.

Thousands terrified at what the future holds; these are proud people who cannot bear to ask for public assistance, and always the cost of living spiraling ever up and up while their standard of living goes down. Is this what this committee wants? Is this what the Congress of the United States wants?

I have no quarrel with the split income tax provision, and certainly there isn't any intention to take this tax privilege away from married people. More power to them and to anyone else who can legally save on their taxes. All we single people ask is the same tax break. We want simple justice for single people. And millions of married people agree with me.

Senator McCarthy. Thank you very much.

Senator Curtis. I have one question. Suppose on one side of the street there is a business operated by an individual, and he makes a net profit of $10,000 a year. Across the street there is another business operated by a partnership, and the partnership is composed of two people, and they make a net profit of $10,000 a year. We will assume that they are equal partners, so that if they divide all the profits each one would get $5,000.

Are you suggesting a principle that the man who owns the business himself and makes $10,000 be taxed on no greater amount than each of these two partners who got the $5,000?

Miss Kellems. May I ask you, Senator Curtis, are these two people married who operate the business?

Senator Curtis. It doesn't make any difference.

Miss Kellems. If they are single, they make $5,000, is that right, $5,000 each?

Senator Curtis. The partnership makes $10,000.

Miss Kellems. But the point here at issue is whether the people are married or single. If the single person makes $10,000 a year, then we are asking that he be taxed at that rate.

Senator Curtis. I understand what you have said, but I have asked you a hypothetical case.

Miss KELLEMS. I can't answer it.

Senator CURTIS. You have got one businessman operating alone who makes $10,000. A similar business is operated by two partners. They make $10,000, five for each one of them.

Now, do you believe that the man who makes $10,000 for himself alone should not be taxed on any greater amount than the amount taxed to each one of these partners in a similar business?

Miss KELLEMS. My position is that if they are all single——

Senator CURTIS. No, no; that has nothing to do with it.

Miss KELLEMS. You see, I believe in equal taxation for everybody, which is a percentage. I think we would be far better off if we junked everything that we have got in this book and make a simple tax of a certain percentage for everybody.

Senator CURTIS. Well, even if we did that, would you apply that tax to $10,000 for the one man and to $5,000 for each of the other two?

Miss KELLEMS. Certainly, because this is what they are earning. This is an income we are taxing.

Senator CURTIS. When I got married I entered a partnership.

Miss KELLEMS. Yes, did you live in a community-property State?

Senator CURTIS. No. This was purely voluntary, believe me.

There is a notion afloat in the world that some way with the magic term of reform we can lower everybody's taxes, and have plenty of money for everything. I haven't been able to figure it out.

Miss KELLEMS. I feel, Senator Curtis, that our approach is wrong. In my opinion, operating the Government of the United States, in principle, is identical with the housewife operating a home, and what she does is to first determine her income.

Senator CURTIS. Hers or her husband's?

Miss KELLEMS. Well, whatever the income is that comes in to support that home. Then she decides what she can afford to spend. Now, I feel that if the Federal Government would first determine its income, and then see how many of these plain and fancy schemes they can afford to have, we might have better government and we certainly would have fairer taxation.

Senator CURTIS. I agree with that 100 percent.

Miss KELLEMS. Good.

Senator McCARTHY. Senator Ribicoff?

Senator RIBICOFF. Miss Kellems, will you describe to us briefly your education and training in the field of economics and taxation?

Miss KELLEMS. Well, I am in the process of getting a Ph. D. from the Edinborough University. My education goes back 50 years. I have a master's degree from the University of Oregon and a year's resident work at Columbia University under Professor Seligman, and this goes back 50 years, but even today I think any self-respecting library anywhere in the world will have copies of Seligman's essays on taxation.

It is still the standard work. I started to get this degree at Edinborough, and I have finished everything except the thesis, and that would be done now, except that in pursuit of this research I stumbled onto the fact that there is no law that says single people have to pay at a higher rate, and in pursuing this and finding out about it, the degree has had to sort of wait.

If Congress would just please pass this law and let me get back to my studies, everybody would be better off.

Senator CURTIS. It looks like we are going to have a long recess.

Miss KELLEMS. I am very hopeful that Congress will take action and pass this bill.

Senator RIBICOFF. That may depend. What do you estimate the cost of Senator McCarthy's bill would be?

Miss KELLEMS. I would like to put it another way, Senator Ribicoff. How much are you going to take away from the single people unconstitutionally? Now, I think Mr. Adams, when we first discussed this, had a figure of $1.6 billion, which was the Joint Committee on Taxation's figure. I think Senator McCarthy, in his speech on the floor of the Senate, estimated that for this year it would be $1.9 billion. Isn't that correct, Senator McCarthy?

Senator MCCARTHY. That is about right.

Miss KELLEMS. You estimated $1.9 billion. Now, this seems like a very large sum of money, but there are just two or three small things that could be done that could easily replace these funds, but I don't know if you are interested in my opinion as to what the Government should do to offset this so-called loss.

The loss is not to the Government if they go through and continue this taxation. The loss is to the single people, and I might say that we are coming to a confrontation, because the Treasury has issued a summons to me and to my accountant for all of my documents and papers in great detail for 1966, 1967, and 1968, with the idea, I suppose, that they will do what they did before.

They will levy a very large tax on me to try to shut me up, but I don't shut up easily, as you know, Senator Ribicoff.

Senator RIBICOFF. I am delighted to see you again and see you looking so well. I am pleased that you have recovered from your slight indisposition.

Miss KELLEMS. That is all right. I always bound right back.

Senator MCCARTHY. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Miss Kellems, I am sorry that you were not more successful many years ago with some of your advocacy of a balanced budget, whether a family budget or a Government budget, but the sad situation is that we do not have a balanced budget.

We are not in a position where we can do what we would like to do, and so we have to take matters in priorities. I think you will agree with me on that, will you not? Priority is what comes first.

I would just like to ask this question. And, incidentally, I agree with the part on the head of the household that you have made in your recommendation, but in weighing the priorities, do you feel that a $600 allowance for a child is sufficient, and how would you compare that to the burden that is placed on the single person on ability to pay?

Miss KELLEMS. Of course, I don't believe in ability to pay. I think that everybody, everybody, should pay a tax, because what is a tax? It is Government. You are buying Government. And every person should pay, even a small person should pay a little so that they are contributing to their Government.

Now, I am an old lady and not married and not even an unmarried mother. I feel that $600 is not adequate for a child. One thing I think that should be said is that I have thousands of letters from single people saying, "Why should we pay taxes to educate the children of married people", so this is something.

I personally, Senator Fannin, take a very pessimistic view of the whole thing. We are now coming to the full realization of what the so-called Keynesian philosophy has done. We started this, as you know, many years ago. Lord Keynes was the great economist who said you can inflate a currency about 3 percent a year.

Well, it is like taking a drug. It is true you can start with a tiny little bit, but presently in the morning when you wake up, in order to even feel normal you must take that amount of that drug.

Then it goes and you keep increasing and increasing, so that today the Keynesian theory to me stands for exactly what it is. We now have runaway inflation, and I feel that if you would reduce taxes, that is the quickest way to stop inflation in this country, because every tax that is levied is added to the price of something.

Senator FANNIN. Unless we add it onto our debt.

Miss KELLEMS. All right, but where do we go with this debt? Lord Keynes never said where we are going with this debt, but let me give you an example I often use.

Take a chair, a wooden chair. From the time that chair is a tree in the forest and it is cut down and put through one process after another until it is finally a chair, every person who touches it pays an income tax, and that percentage of that income tax is added to the price of that chair. So if you would do away with the income tax, if you would do away with this tremendous tax—and I am very realistic. We are never going to repeal the income tax. Let's face it.

The country would go into chaos if you did. You can't do that. But you can stop all of this ridiculous gobbledegook.

Look, we have gone so far in this country. Here is an Encyclopedia of U.S. Government Benefits. Now, think of it. Take a look at that book. You can even get your kitchen done over. There are all kinds of things. What business is this of Government?

Senator FANNIN. I will agree. I am disagreeing with you at all, but I am just trying to be realistic as to what we do first. In other words, we have a bill here before us, and I think we should start to think about priorities.

Miss KELLEMS. Well, don't we also consider constitutionality? Does the Congress wish to act illegally, because this is an unconstitutional law.

When this was debated in Congress in 1948, Senator Fulbright said that it discriminated against the taxpayer because of geographical location, and he said, "Show me any other tax law that discriminates against a taxpayer because of the place where he lives."

I would like to ask Senator Fulbright to show me any other law that discriminates against a taxpayer because that taxpayer is single. If you are going to discriminate and put a penalty on us because we are single, and believe me millions of girls are single involuntarily, there aren't men enough to go around; if you are going to do this, then why don't you tax us more at a higher rate on our property taxes?

Senator FANNIN. I am very concerned about property taxes.

Miss KELLEMS. Yes, I am, too.

Senator FANNIN. That is perhaps one of the most inequitable taxes of all.

Miss KELLEMS. There is no doubt about it.

Senator FANNIN. Thank you very much. I just don't know exactly what we can do at this time that would bring about what your goal is presently and has been for many years, but we do need to have priorities, and that is why I was asking these questions. How can we determine just where we should start?

Miss KELLEMS. But, Senator Fannin, millions of these people are being put into bankruptcy because of this tax. I would like the committee to read these letters. You can't read them and not shed tears. This is a terrible thing. We are creating paupers out of these people.

Senator FANNIN. I am not in disagreement with you in that respect, but I also know that there are many people with families, with children, that cannot send their children to school and cannot meet their obligations, and so we have a great problem in all of the categories that we are talking about.

I appreciate the information that you have given us.

Miss KELLEMS. Well, I agree, but I feel that if the Congress does not take action, this question will undoubtedly go to the Court, because I am going to sue the Government for all this money that they owe me, and they are acting lawlessly and illegally now, trying to take my documents to collect a tax that is illegal in the first place.

This tax has never been submitted to the Supreme Court, and I am quite sure as soon as the timing lapses, you have to get permission from the Government to sue them, and as soon as I get permission, I am going to sue the Government for that money.

In the meantime, they are going to probably sue me to get my records. I think it is going to be quite a confrontation.

Senator FANNIN. We could all agree on that.

Miss KELLEMS. Yes.

Senator MCCARTHY. Miss Kellems, I understand your constitutional position is that if we allow deductions for wives and also for children, in some particular amounts, it might be constitutional, but to allow the split income simply because people are married, at a different rate from those who are single, that this is truly unconstitutional.

Miss KELLEMS. I feel that, Senator, because if you establish this principle, how far are you going to go? If you can tax a person because they are single, all right, then you can tax a person because that person is an orphan, or because of their church affiliation or their political parties. You might tax a person eventually, you might have a Government who might tax somebody because they just plain didn't like them.

Senator MCCARTHY. Short people against tall people?

Miss KELLEMS. Yes. I am afraid I would come out as compared with you at the little end of the stick, if they started taxing people because they are short. But this is the principle.

Senator MCCARTHY. And you feel that Judge Haynsworth in the decision indicates he has very bad judgment?

Miss KELLEMS. Yes, I think it is the most idiotic decision——

Senator MCCARTHY. That not just the decision is bad but that the opinion is also bad? That is even more serious in a Supreme Court Justice. He might have a bad decision with a good opinion, or a bad opinion with a good decision, but in this case it is bad on both counts.

Miss KELLEMS. I am not qualified to pass on Judge Haynsworth or his qualifications for the Supreme Court.

Senator MCCARTHY. But in this case, however,—

Miss KELLEMS. But in this case I think this is the most dreadful thing. Would you like me to just read briefly?

Senator MCCARTHY. I think you should.

Miss KELLEMS. What he said here?

Senator FANNIN. Is it in the testimony?

Senator MCCARTHY. She skipped it, but I think we ought to let her read it.

Miss KELLEMS. It is most interesting. The court of appeals stated on page 389:

> Taxpayer seeks to recover the difference in the tax paid upon her 1954 income and the amount of tax which would have been due if a husband and wife reported the same income and deductions upon a joint return. Permitting married taxpayers to use the split income device of No. 2 of the 1954 code, 26 U.S.C.A. No. 2, while withholding the privilege from single persons she says is such an arbitrary and unreasonable discrimination that it cannot be allowed under the Consitution. Classification of taxpayers according to marital status is not unreasonable, however, and there was much reason behind the purpose to equalize the tax burden as it falls upon married couples in common law States in comparison with those in community property States. The fact that the change gave a proportionately greater tax reduction to married couples with large incomes is wholly irrelevant; if the rapid acceleration of the progressive tax rates run afoul of no constitutional guaranty, a slight withdrawal may not be said to have done so. We find no merit in the taxpayer's contentions.

Now, in simple English, with all that out, Judge Haynsworth said that an increase of 40 percent in Mrs. Faraco's tax, because her husband died, was so slight, that is the word he used, a "slight withdrawal," did not violate the Constitution.

Now, since when does the amount determine the constitutionality of a law? You could have $1 discrimination and it could violate the Constitution. As I say, I have nothing personal against Judge Haynsworth. I don't know anything about his record at all except that this one case was enough for me.

Senator CURTIS. Miss Kellems, you are reading something in that that isn't there.

Miss KELLEMS. What is it, then?

Senator CURTIS. He said, "If the rapid acceleration of progressive tax rates", something that you are very much opposed to——

Miss KELLEMS. I beg your pardon?

Senator CURTIS. That is something you are very much opposed to.

Miss KELLEMS. I certainly am. It is pure Marxian doctrine.

Senator CURTIS. Yes. He says—

> If the rapid acceleration of the progressive tax rates ran afoul of no constitutional guarantee, a slight withdrawal may not be said to have done so.

He is not saying that the amount of the tax in this case, the differential, is slight. He is comparing it with the accelerated progressive tax rates that we have that he says have not been held unconstitutional.

Miss KELLEMS. What does "slight withdrawal" mean?

Senator MCCARTHY. I think this runs against the judge, really. This was not the issue, the rapid acceleration of tax rates——

Senator CURTIS. No, I don't think so. I think he is comparing what has happened here with the accelerated tax rates. He said so.

Senator FANNIN. I don't know that Judge Haynsworth is the only one. It may have been ruled on in many cases. I can't say that has set a precedent.

Miss KELLEMS. But this is the only case that has ever bit the Court, and I cite it because the Secretary of the Treasury's chief counsel wrote this to me. He sent this to me, and I looked up the case.

Senator FANNIN. I think you should go further than that and determine. You say it is the only case. I don't know how much research has been done in that regard, but I think it shouldn't be taken for granted that this was done, but we should certainly make that determination.

Miss KELLEMS. What determination? I am not clear.

Senator FANNIN. As to whether or not he is all alone in his ruling?

Miss KELLEMS. I haven't been able to find any other, and I have had several lawyers looking at this, and as I say, of course, I thoroughly disagree with the progressive rate. It was Marx and Engel who cooked that up, and it was Vice President Garner, serving in the House of Representatives in 1913, who insisted upon it, because the 16th amendment makes no provision for a progressive rate, and it runs contrary——

Senator FANNIN. All I am saying is that we can't blame Judge Haynsworth.

Miss KELLEMS. I am not blaming him. I am merely putting this in the record. This is what he said. I may interpret it wrong. Anybody can interpret that as they please, but to me, and I have had some lawyers look at that, they say that means that a slight withdrawal, 40 percent I consider more than slight, may not be said to run afoul of constitutional guarantees.

Now, what does that mean to you, Senator Fannin?

Senator FANNIN. Well, of course, I would have to see the amount, see the determination, and I could not just without having more information make a statement on the subject.

Miss KELLEMS. I have only what the Treasury sent me.

Senator FANNIN. I don't even have that.

Miss KELLEMS. It is in my testimony.

Senator McCARTHY. I have just two points.

One, I think the only point in your testimony I object to is you seem to imply that members of the committee are supposed to understand the Internal Revenue Code.

Miss KELLEMS. Do you understand it?

Senator McCARTHY. That is an unreasonable demand. We don't even ask the staff to understand it.

The other is a clarification of what you said about Joseph selling the Egyptians into slavery with their own money. Would you explain that scripture reference?

Miss KELLEMS. It is a very nice story from Joseph's viewpoint. Most everybody thinks of Joseph, who was his father's favorite son and wore a coat of many colors and was sold into Egypt by his brothers into slavery, which all is very true, but the truth of the matter is that the Pharaoh had a dream, and the dream was of seven fat cows that came up out of the river and started eating the grass on the riverbank, and then seven lean cows came up. They didn't eat the grass. They ate up the fat cows, and the Pharaoh was very upset.

He went to sleep and he dreamed again, and he dreamed that there were seven ears of corn, fullbodied and well and healthy, and then there were seven very ill-favored ears of corn that came up and ate the seven good ones.

Nobody could interpret the dream, and a cupbearer who had been in prison with Joseph remembered that Joseph had interpreted a dream for him, so he asked the Pharaoh to bring Joseph out of the prison to interpret the dream, which the Pharaoh did, and Joseph said:

> It is very simple. There will be seven years of plenty followed by seven years of drought, and we should amass all that we can to care for the bad years.

Well, the Pharaoh was very pleased and he made Joseph second in command. Joseph had everything.

Senator McCarthy. Commissioner of Internal Revenue?

Miss Kellems. Yes, Commissioner, he could have been.

At any rate, while the 7 years of plenty were going on, and they had these bountiful crops, Joseph taxed the people 20 percent, and it is most interesting how throughout history this percentage of 20 percent crops up time and time again. But at any rate, Joseph taxed the Egyptians 20 percent of their income. This was an income tax, and he built tremendous graineries and he had places for the stock and the cattle and everything, and he gathered all of this tremendous wealth into the Government.

And then the 7 years of famine came, and the Egyptians came to Joseph and said, "Look, we are starving. Give us some food."

So he said, "How much money have you got?"

So they took all their money and they gave it to Joseph and he took out of the stocks and gave them food. This was theirs in the first place, remember. It came from them.

Then they ate that and presently they were hungry again and they came back and they said, "Look, we can't do anything. What can we do? We are starving."

He said, "What about your flocks and your herds? Bring them to me."

So they brought all of their cattle and their herds and they gave them to Joseph, and he gave them food.

Then that was gone, and they came back and said, "Now, what can we do? We are starving."

Joseph said, "What about your land? You deed your land to the Pharaoh and I will feed you."

That is what they did. In other words, the Pharaoh owned everything, and after the drought Joseph gave them seeds and they planted, but they were working for the Pharaoh, because he owned everything, and that is precisely what is happening in this country.

Senator McCarthy. Seven years?

Miss Kellems. Seven years. Well, I don't believe we can last 7 years, Senator McCarthy.

Senator McCarthy. Thank you very much.

Miss Kellems. You are very welcome.

(Miss Vivien Kellem's prepared statement follows:)

Statement of Miss Vivien Kellems, East Haddam, Conn.

SUMMARY

1—Brief History of the Community Property Law, passed in 1948, which resulted in the penalty tax on single people.
2—Analysis of this law.
3—Attempt to test the Constitutionality of the penalty tax.
4—Bill S2794, Introduced by Senator Eugune McCarthy, August 7, 1969.
5—Action taken by Miss Kellems to test the constitutionality of the penalty tax.

The first income tax law passed under the Sixteenth Amendment in 1913, consisted of 40 pages. The latest, published July 22, 1968, is 1593 pages. Titles, subtitles, tables, texts, cross-references, special rules, miscellaneous information, all in very fine print, is one vast labyrinth of gobbledy-gook. Can the most brilliant lawyer, the most adroit and versatile accountant, can the Secretary of the Treasury, can anyone of you gentlemen on the Finance Committee, possibly grasp and understand this fantastic monstrosity we call our Income Tax Law? And this does not include volumes of court decisions, regulations, special rulings, and other paraphernalia.

Congress now proposes to "reform" this hydra-headed monster: close a loophole here, put a path on there, levy more on one hapless taxpayer, give a crumb of benefit to another. When finished, the whole mess is going to be more incomprehensible and hopeless than it is now.

Naturally the whole thing is shot through with favoritism, injustices and inequities. The most blatant and unconstitutional of them all is the penalty tax against single people.

There is no law that says single people must pay higher income taxes just because they are single. Congress never has, nor does it dare to pass such a law; even this Supreme Court would have to declare it unconstitutional. Then how is it possible that for the past 21 years, the Federal Government has sucked into its cavernous maw billions of dollars from American citizens on the pretext that it is legal to penalize people for not being married?

It was done in 1948 with a sleight-of-hand trick called the Community Property Law which wasn't a Community Property Law at all. That was the excuse given for the wholesale robbery of millions of helpless people.

It all began when the Income Tax Amendment to the Constitution was adopted in 1913, and came about because our laws are derived from two different systems, the Spanish Law and the English Common Law. At the end of the Mexican War, Mexico ceded to the United States that territory now comprising New Mexico, Arizona, California, Idaho and Nevada. As each of these states was admitted to the Union, it embraced most of the English Common Law, but retained those Spanish Laws protecting the rights of the wife to one-half of the property acquired after the marriage, also one-half of the income earned by the husband. These laws were inherited from Mexico which in turn, had adopted them from Spain.

Texas came into the Union by treaty, an independent nation, but Texas had already put the community property laws in her Constitution. Louisiana was acquired by purchase from France, but the French community property law was practically the same as the Spanish, so one more community property state came into the Union.

The rest of the states derived their laws from the English Common Law and gave no such rights to wives. As Senator Connally said, women in many of these states were little better than serfs. In some states it was legal for a man to beat his wife, provided the switch was no thicker than his thumb.

When the first income tax law was passed under the Sixteenth Amendment, the Internal Revenue Service recognized these community property laws and permitted married people in these seven states to split their incomes and pay at a lower rate. Since these first income taxes were very low and exemptions relatively high, the rest of the country paid no attention to this special benefit enjoyed by their sister states. However, after the first world war when income taxes reached astronomical heights, the common law states came to with a bang. How come? Why weren't they entitled to the same tax break?

The first bill to equalize these rates was introduced in Congress in 1921, but went down to ignominious defeat. The community property states refused point blank to extend this lucrative loophole to the rest of the country. They had a good thing going and didn't propose to give it up. Again and again the common law states tried to pass this bill, but each time they lost. As Senator Fulbright said, these bills were "filibustered to death". Due to the lower taxes paid by married people in the community property states they were sitting pretty; the common law states were paying a disproportionate share of the cost of the Federal Government.

By 1947 the battle lines were drawn and feelings ran high!

The very first bill introduced in the 80th Congress was House Resolution No. 1—to reduce income taxes. The House passed this bill and sent it to the Senate where Senator McClellan immediately proposed an amendement to pass on the blessings of split income taxes to the rest of the country. By this time five more states, Michigan, Nebraska, Oklahoma, Oregon and Washington had passed community property laws, making a total of twelve such states. Senator McClellan's amendment proposed to bring the other thirty-six states under this protective tax umbrella.

It was a lighted match and fireworks exploded on the Floor of the Senate. Senator McClellan charged that the Community Property states were getting away with murder. He claimed the common law states were paying $500,000,000 a year more than the community property states, an advantage to these twelve states of $175,000,000. He was grieved that Arkansas, his home state, paid $5,000,000 more in federal taxes in 1946 than a community property state of comparable population would have paid. To the distinguished Senator this was an unbearable penalty inflicted upon his state and "the rankest and most unjust discrimination that exists anywhere in our tax laws against three-quarters of the states". "Such a monstrosity in our tax structure" was not to be borne and he demanded "righteous and equitable treatment for simple justice to all American citizens alike." But to Senator McClellan and 99% of that august body, such "righteous and simple" justice did not apply to single people.

Throughout the debate the only words used in referring to the taxpayers were the "citizens" or "people of my state" or of the United States. The words "single people" appear only three times in that whole, lengthy debate that stretched out over months. Senator Millikin rather timidly ventured the opinion that there were other people to be considered. He suggested that there might be "important effects on the distribution of taxes among the different income groups between married and single persons". And at another time, "I am emphasizing that we are dealing with a group problem. Under the Senator's amendment a single person living alone would not benefit. Widows with children would not benefit. Children with dependent parents would not benefit."

But the Senator might just as well have saved his breath. Not one member of that "most exclusive club in the world" even heard the word *single.* Even *widow with children* failed to register. Senator McClellan tartly replied, "the bill does perpetuate a group benefit which now accrues, and I am trying to quit perpetuating this group benefit to the community property states." And the rest of the Senators went right on prattling about the "citizens of my state," or the "citizens of the United States," or the "people" of the state or nation. To them there were no single people; *everyone* was married.

Incredible! Suffering poignantly from "blatant injustice" they were utterly oblivious that they were shunting off onto the frail shoulders of those least able to pay, the whole weight of the burden which they were determined to dump from their own. There was no pretense; it was a straight tax gimmick. It unabashedly gave a tax advantage to one class of taxpayers. One member assured Senator McClellan that the Ways and Means Committee would "consider this matter with the greatest sympathy". To which the Senator from Arkansas replied, "I want a reduction in taxes, not sympathy." He then informed Senator Knowland, "On our present salary ($12,000) I pay $646.00 more Federal tax than does the Senator from California. I need that money for my family as much as does the Senator need that amount of money for his family. All I am asking is that justice be done." The saving on the present Congressional salary is over $4500.00.

It was then suggested that Arkansas could pass its own community property law, but this was not easy. The five states that had passed such laws did so in self-defense with the greatest difficulty. Another state, Pennsylvania, had passed such a law only to have the Supreme Court of Pennsylvania declare it unconstitutional. Community property laws created all kinds of problems affecting estates, domestic relations and commercial credit; they could upset court decisions and cause individual and general chaos. Senator McClellan didn't think much of that idea; the only solution to his problem was a Federal Law; he would settle for nothing less.

At this point Senator Connally invited the Senator from Arkansas to move to Texas and this brought up another sore point. While the Senator couldn't very well move to Texas, that was exactly what a number of his constituents were doing. The town of Texarkana was divided right down the middle by the state line between Texas and Arkansas and many wealthy citizens of Arkansas, whose businesses were in that state, found it profitable to move their homes across the state line to Texas where they happily split their incomes and paid Uncle Sam at the lower rate. Other states lamented loudly that the Community property states were siphoning off the wealth and business of the non-community property states. They did, indeed, have a good thing going!

Senator Fulbright termed it "geographical discrimination" and he challenged any Senator to "cite any other case where we make a distinction and a difference in the tax burden because of citizenship in a particular state or states."

I ask Senator Fulbright, show me any other tax law which makes a distinction and a difference in the tax burden because of the marital condition of the taxpayer?

The bill did not pass in 1947. However, it was one of the first bills passed in 1948. On April 1, 1948 President Truman vetoed it, calling it "inequitable". The very next day Congress passed it over his veto.

It should be made quite clear that this was *not* a community property law. Not one property law, or any other law, was changed one iota. Not one piece of property, or penny of income changed hands under this law. No wife anywhere received one thing except as she benefited by the tax savings. Everything remained precisely as it was and the husband still owned his income. It was a straight tax gimmick, class legislation and discrimination of the most flagrant sort. There was absolutely no pretense. It was a rich, married taxpayer's bill, the higher the income the greater the *percentage* of saving. Poor married couples, those receiving $5000 or lower, didn't save a dime. The single taxpayers were left holding the bag. They had to pay at the confiscatory rates of World War II without a penny of relief. Never has a law been passed saying they must pay at these exorbitant rates, but under this so-called community property law, the Internal Revenue Service has arrogated to itself the power to illegally collect billions and billions of dollars from these helpless people.

But more than this, the law gave the rich, married people in the community property states something they had not had before. They could now split *all* income, including that derived from premarital estates. This they could not do before. But under this law rich, married people in all 48 states could split this income, and thereby save themselves billions of dollars. Add to this the estate tax which permits them to pass on one-half their estate with no tax, while the other half is taxed at the lowest rates, and the picture is complete. They had it made! To finish off the single taxpayer, when he dies 100% of his estate is taxed.

But before his sad demise, one more indignity—the Surtax! Since there wasn't one more thing to tax. Congress taxed a tax. This was not a tax on income, this was a tax on the income *tax* and again the single person had to bear the brunt of it. 10% for married people, but up and up and up for single people because they have to pay 10% on the penalty they are already paying. In thousands of cases it runs over 14%. I make no comment on this action; the facts speak for themselves.

Has there ever been such rank, discriminatory, unjust, unconstitutional legislation against millions of American citizens? Why? Because they are not married.

There has been one attempt to test the constitutionality of this system. The day after Christmas, 1953, one Mr. Faraco died. The very next year, the income tax of his widow was raised 40% because she was now a single person. Mrs. Faraco resented this unjust penalty for having lost her husband, and brought suit to recover this money in the Tax Court of the United States. The Tax Court refused to consider the constitutional issue, and the case, *Antoinette M. Faraco*, 29 T C 674 (1958), was appealed to the Court of Appeals for the Fourth Circuit and that court held that the law was constitutional (Faraco v. Comm., 261 F. 2d 387 (4th Cir., 1958)).

The Court of Appeals stated, page 389:

"Taxpayer seeks to recover the difference in the tax paid upon her 1954 income and the amount of tax which would have been due if a husband and wife reported the same income and deductions upon a joint return. Permitting married taxpayers to use the split income device of #2 of the 1954 Code, 26 USCA #2, while withholding the privilege from single persons, she says is such an arbitrary and unreasonable discrimination that it cannot be allowed under the Constitution. Classification of taxpayers according to marital status is not unreasonable, however, and there was much reason behind the purpose to equalize the tax burden as it falls upon married couples in common law states in comparison with those in community property states. The fact that the change gave a proportionately greater tax reduction to married couples with large incomes is wholly irrelevant; if the rapid acceleration of the progressive tax rates ran afoul of no constitutional guaranty, a slight withdrawal may not be said to have done so. We find no merit in the taxpayer's contentions."

In plain English, this decision says that because the increased tax of 40% was so "slight" it did not violate the Constitution, and without doubt, is the most idiotic decision in the whole legal history of the United States. Since when does the *amount of damage* determine the constitutionality of a law?

That decision was rendered by Judge Clement F. Haynsworth, who has recently been nominated for the Supreme Court.

The Supreme Court refused to rule on this question by denying certiorari (359 U S 925 (1959)) and until it does rule, the constitutionality of the penalty tax on single people simply because they are single, has not been established.

In 1962, Senator Eugene McCarthy, of Minnesota, introduced a bill (S35) which would permit certain persons 35 years of age, or over, to qualify as Head of Household, and pay a lower tax, however, not as low as married persons in the same income tax brackets. There was already a rather nebulus classification, Head of Household, which Congress had added in 1951, to partly still the cries of outrage from indignant taxpayers, but the requirements were so strict that very few people could qualify. For all the relief it afforded, it might as well not been there.

Senator McCarthy sought to amplify this classification to include many more over-burdened single taxpayers. He got exactly nowhere. He was a lone voice crying in the wilderness. In spite of the lack of understanding and co-operation, even ridicule, the Senator persisted and has reintroduced this bill in each succeeding Congress (88th, 89th, 90th). Convinced of the injustice of the penalty tax and also persuaded that it was unconstitutional, Senator McCarthy felt that it was the best bill that could be considered at that time, since there was such opposition to the whole idea of fairness and justice for single people. Later other Senators joined him in sponsoring the bill and several Congressmen have introduced similar bills in the House of Representatives.

And the Ways and Means Committee recently actually included such a measure in its proposed tax reform bill. This action reflects the change in the political "climate" regarding this tax.

Finally, Senator McCarthy stood on the Floor of the Senate on August 7th, this year, and introduced a bill (S 2794) to abolish the whole unsavory, unconstitutional mess. He was heartily commended by Senator Ribicoff, of Connecticut, who pledged his support of the bill. Senator Ribicoff said, "The Senator from Minnesota has been in the forefront of this fight for many, many years. He has been a lone voice, receiving very little support from anyone else in the executive branch or in the legislative branch. I will certainly be pleased, as a member of the Committee on Finance, to support the Senator's efforts to bring justice in this important field."

It is this bill, Gentlemen, which brings me before your Committee today.

On April 15th, I signed a blank income tax form (1040) and sent it to the Director of Internal Revenue, Andover, Massachusetts. I then wrote the Secretary of the Treasury that I would not pay any more taxes until the Federal Government refunded to me the sum of $73.409.03, taxes which have been illegally collected from me for the past twenty years, plus interest.

From that time, letters have poured in from all over the United States. As their numbers increase, my blood pressure rises! They come from all over the country, from all kinds of people, young people working their way through college, elderly widows trying to make ends meet on meager incomes, school teachers, nurses, telephone operators, stenographers, secretaries, factory workers, and thousands of retired people—a cross section of America. All tell one bitter, heart-breaking story, a crushing penalty tax by an all-powerful, greedy, ruthless government for one reason only, these millions of people are not married.

What began as a simple test of the constitutionality of this tax, has now become a flaming, emotion-packed crusade.

We are creating paupers out of decent, self-respecting, self-supporting American citizens. Read these letters and see if you can stay calm; widows with small children, women whose husbands have been killed in Vietnam and who must pay a penalty for the sacrifice they have made, other widows using the capital of the small estate left by a husband to pay current taxes, one woman living on crackers and tea. Thousands terrified at what the future holds; these are proud people who cannot bear to ask for public assistance, and always the cost of living spiraling ever up and up while their standard of living goes down. Is this what this Committee wants? Is this what the Congress of the United States wants?

I have no quarrel with the split income tax provision, and certainly there isn't any intention to take this tax privilege away from married people. More power to them and to anyone else who can legally save on their taxes! All we single people ask is the same tax break. We want simple justice for single people. And millions of married people agree with me.

Senator McCarthy. We will recess until 9:30 tomorrow.

(Whereupon, at 3:05 p.m., the committee adjourned, to reconvene at 9:30 a.m., Friday, October 3, 1969.)

APPENDIX A

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF REAL ESTATE DEPRECIATION

Written testimony received by the Committee expressing an interest in the subject of real estate depreciation

Statement of Owens-Illinois, Inc., submitted by Floyd M. Canter, Executive Vice President Commercial and Technical Administration

Section 521 is aimed at thinly capitalized real estate companies and ventures by limiting depreciation on new construction to the 150 percent declining balance method. However, in attempting to correct some abuses, the Bill penalizes all building depreciation including that of manufacturing facilities constructed by the user.

The rapid technological progress being made by American industry tends toward obsoleting manufacturing buildings almost before they are built, particularly in the case of special purpose buildings. Because of technological progress, more and more buildings are being designed to the particular needs of a manufacturer. The double declining balance and sum of the years-digits methods of depreciation give some recognition to the potential obsolescence and deterioration as an "ideal manufacturing facility." The restriction to 150 percent declining balance on new construction and straight line depreciation on used buildings will tend to restrict industrial construction, placing American business at a further disadvantage as compared to foreign business where, in some countries, write-offs of as much as 50 percent of a plant are allowed in the first year and where numerous special incentives for modernization of facilities are provided.

At the time that repeal of the investment credit was announced, the Treasury Department indicated that it was at least thinking of liberalizing depreciation methods with triple declining balance being given as one of the methods under review. Section 521 works in the opposite direction.

The Treasury Department currently has at its disposal several tools which could be used to restrict blatent abuses. The first of these is the life assigned to the building; the second is disallowance of interest costs on thinly capitalized companies. If strengthening of these tools is needed, we would concur; but we do not believe that all building construction should be penalized for the abuses of a few. Rather, we should request additional incentives to encourage American business to remain or become competitive with foreign operations who benefit from the above mentioned incentives.

We also strongly urge that the present tax rules regarding recapture of accelerated depreciation be retained rather than imposing complete recapture as proposed by Section 521. This retains the penalty in speculative investment in real estates without unduly penalizing those who after using a building for a number of years must dispose of it because of changing economic conditions. The present recapture provisions guard against abuse of the accelerated methods of depreciation without unduly taxing appreciation in dollar values caused by the continued inflationary trends in our economy. Where a building is used in bona fide business operations for substantially more than a decade, the complete recapture proposed by Section 521 would tax inflationary increases in value, which have nothing to do with misuse of accelerated depreciation, at ordinary income rates. Proposed Section 521 would, therefore, completely circumvent the capital gain provision with respect to the very kind of value appreciation to which the capital gain provisions historically have applied. Such a drastic change in fundamental tax policy, we believe, should not be so casually made.

Statement by Alex D. Hegel, President, Sierra National Corporation

CUTBACK IN DEPRECIATION ALLOWANCE COULD RESULT IN SERIOUS DAMAGE TO U.S. ECONOMY

The so-called "tax reform" bill now pending in the U.S. Senate will definitely jeopardize our nation's entire economy if enacted in its present format.

This sober fact of life seemingly has been overlooked in most discussions revolving around the controversial tax law measure.

Take, for example, the housing industry (single family residences, apartment houses and mobile homes) which constitutes the largest segment of our gross national product.

Proposed provisions in the "tax reform" bill modifying depreciation allowances and reducing income deductibles cannot but have a negative effect upon investment sources—once the latter become fully aware of the bill's restrictions.

Ironically, Cabinet member George Romney has repeatedly stressed the need for building more than two million (2,000,000) housing units next year. Even with existing depreciation allowances this goal would be exceedingly difficult—if not impossible—to meet.

And, if the depreciation cutbacks written into the bill already passed by the U.S. House of Representatives and now being discussed by the Senate Finance Committee remain unchanged, there is serious question whether even fifty (50) percent of the required two million housing units would be built during 1970.

Simply stated, investment capital—so absolutely necessary to underwrite these critically needed units—will not have enough incentive to invest and build!

Along with tax reform, one of the more widely debated issues of the day concerns employment for underprivileged minority groups. A flourishing construction industry can provide more employment opportunities for these groups than any other segment of our economy, economists point out.

Their position is well-taken because a thriving residential construction industry automatically generates increased production, and more jobs) for steel, lumber, copper and carpet mills; concrete and gypsum plants; paint, glass and roofing material manufacturers—and numerous related industries.

The largest segment of present employment for underprivileged minorities already lies within these industries, it is generally agreed. Therefore, it should be evident that if investment capital's incentive to finance residential construction is dampened, such construction will inevitably decline—and, with it, corresponding job opportunities for the presently unemployed.

It becomes increasingly clear, then, that the several restrictive depreciation allowances contained in the pending "tax reform" bill will seriously injure the health of our nation's overall economy—should they be enacted into law.

Statement of Leon London, Attorney, New York, N.Y.

My name is Leon London. I reside at 340 East 51st Street, New York City, N.Y. I have practiced law for 43 years, principally in real estate law. I have also built high rise apartment houses and I have rehabilitated slum buildings.

I have two suggestions to make, one in the direction of inducing investors to rehabilitate slum housing. The tax law should be amended to grant a deferment of capital gains taxes to persons who sell real property and within two years reinvest their profits in the purchase and rehabilitation of slum housing.

The hazards of investment in slum areas are well recognized. The rapid depreciation contained in H.R. 13270 may not be adequate to give that program enough of an impetus to enable us to overcome the deterioration in housing in those areas. A provision deferring taxes, the same as in the case of a condemnation for public use, an involuntary conversion, will provide a further incentive to devote those profits to a satisfying of the great need for rehabilitation of the housing supply in slum areas.

My second sugggestion is that the code be amended to enable a property owner using "straight-line" depreciation to increase his depreciation to the extent necessary to meet his mortgage and amortization payments.

The problem arises in the case of a long term mortgage, with fixed payments to cover both interest and amortization. The time arrives when the amortization exceeds the straight line depreciation deduction.

This occurrence induces the owner to sell his property rather than pay taxes on part of his amortization.

The fact is that property in the hands of the builder is likely to receive better treatment, sofar as making needed repairs is concerned, than the property will receive at the hands of a speculator. The result will be to prevent or postpone deterioration of our housing supply.

It will be less costly to prevent deterioration of existing housing than to build new housing to replace it or to make a major rehabilitation of it.

A principal question before this Committee on H.R. 13270 is neither fiscal nor financial: it is moral: Shall we change the rules of the game while the ball is still in play? "Not the morals of the market place but the punctillio of an honor the most sensitive", to quote the words of the late Supreme Court Justice Cardozo, describing the code applying to a trustee, is the standard for government conduct. Public policy is established by Congress as the rule and guide for the conduct of our people. Lower standards of government conduct teach our children moral lessons which cannot afterwards be eradicated.

The question goes beyond the 5 or 6 billion dollars in additional revenue which the government can take in, or a change of a like amount in the tax which particular taxpayer segments of our society will save as against some other segment. The question is when the change shall take place as to each investor.

As a nation, we are not about to go out of business. In the ordinary course of our national affairs, new bond issues will be written; new buildings will be built; new investments will be made. But if the change in the rules is made while a citizen owns a particular investment, which he made in reliance upon the good faith of government, the change can bring about a loss of confidence which can be as harmful in its effects as a depression.

Many, if not most, of the changes which the House bill proposes are good. But they should be given effect prospectively not retroactively. The widow and orphan who own a particular security should know that while they own it, it will continue to receive the same tax treatment as it did previously. When they make a new investment they will be doing so with their eyes wide open. The doctrine of caveat emptor will then apply; but it will only apply prospectively—on the investments they make today and tomorrow—not on those which they made yesterday. I repeat that it is a question of confidence. It is a question of the confidence which the investor, whether he be a businessman or a widow investing her "mite" can have in the attitude of government.

We have learned through experience that, at the bottom of the depression in the 1930's, bricks and mortar, the railroads and the machines did not change from one day to another; that they were the same the day before the stock market crash as they were the day after. What did change was the climate of confidence. And when the confidence climate changed, it took years to restore it.

The administration is seeking to curb inflation; it is not seeking to bring about a major depression. It has taken years to bring the small investor into the stock market—to make him a partner in American business. And making him a partner in American business is the soundest move the government can make. It brings stability because it makes him a partner in the country's success. This fact is brought sharply home to us when we compare the economy of our country with the economy of countries behind the iron curtain.

Moreover, the moral principle involved is of particular importance today when our young people are looking for guidelines: when crime is rampant in the streets, when the use of drugs is on the increase. If H.R. 13270 should pass in its present form, the young will say: "See, Congress has no moral values; why do they expect us to have them?"

The United States is not an oriental bazaar in which "buyer beware" must be the rule. Nor is it a banana republic in which the administration and the constitution change at the whim of a few men with guns. As the world's leading nation, we must live by the same moral code domestically as we do in our foreign affairs.

It is true that an investor has no vested interest in a particular rate of tax, or in a particular mode of depreciation. The fact is, however, that past government edicts, for example the provision that loans to foreign governments shall not be made to those governments which refuse to pay interest or principal on previous loans, and the one that foreign aid will be denied to governments which take property of American citizens without just compensation shall no longer be given. The same rules of high moral principle should apply to our own citizens.

In the past, when it was decided to change the rules of the game with respect to interest on U.S. Bonds, the rules were made prospective only, *i.e.*, applicable only to future issues of bonds. This principle should be followed now.

I would, therefore, urge Congress to go in the opposite direction for the House bill, sofar as dealing with present investments is concerned. I would go further: I would permit the original owner of a building or a machine to change its depreciation method to a higher one, or a different one. It is only with respect to new acquisitions of buildings, machines and oil wells and other new investments that the change in the rules of the game should apply.

All sorts of complex arrangements have been made between investors in reliance on these provisions of law. Changing the rules now will shake the confidence of the business world and may well ruin numerous investors. Our national honor and our tax needs can both be satisfied by amending H.R. 13270 to provide that the changes proposed by H.R. 13270 shall be operative only with respect to investments made after the date when the Ways and Means Committee first publicized the proposed new "rules of the game".

If you want to entice the private sector back into constructing housing, particularly in New York—after the bath which many of them are taking as a result of the imposition of "rent controls" on housing built after 1947—in the face of constantly rising construction costs, you can do it by providing tax incentives.

It is no answer to this problem to say that we will give the incentives to the fellow who builds tomorrow. If you take away the incentives from those who built yesterday, the private sector will say that tomorrow you will take away the incentive from me and he will not build.

My views are based upon my experience with a large number of real estate owners.

LEON LONDON.

STATEMENT OF THE BOISE CASCADE URBAN DEVELOPMENT, SUBMITTED BY STEPHEN D. MOSES, GENERAL MANAGER

MEMORANDUM ON 1969 TAX LEGISLATION

The Tax Reform Bill (H.R. 13270) passed by the House on August 7, 1969, goes beyond the apparent intention of the Administration and a concerned Congress to reform existing tax laws in order to prevent abuse by which certain wealthy individuals (according to studies, approximately 155) have escaped all income tax by utilizing alleged "loopholes" to shelter income. The proposed legislation appears to have been drafted without adequate consideration of its technical aspects. It passed the House with virtually no debate or serious consideration of the overall effect such formidable legislation will have on society, particularly (and in some instances, singularly) with respect to the real estate industry, that critical sector of the economy which assumes substantial risk to provide the facilities in which we live and work.

Tax reform, such as a minimum income tax for wealthy individuals is needed and would be welcomed but should be accomplished by laws which are designed to that end and which do not place one segment of the nation's economy in a seriously non-competitive position by generating inequities and uncertainties as to the tax status of an investment. The country faces a critical need for more facilities. They will not be constructed if the equity investors in real estate are not provided equitable opportunities for a fair return on invested capital. These investors have complete freedom of investment choice. To attract the capital it needs, real estate must be clearly competitive with other investment forms. The full impact of the proposed legislation on a patricular individual does not seem to be susceptible to precise calculations because of the overly complex rules which will affect each individual, but it is clear that real estate will no longer be sufficiently competitive to attract equity investments.

A dynamic growing construction industry is necessary to provide essential jobs for our growing work force. The need of the country for new housing and related commercial facilities has never been greater. The labor force must be supplied with new blood. If construction is impeded, where will these new workers be trained?

Specific provisions of the legislation are discussed hereinafter. The net effect of these provisions, if enacted, would be to reduce specific tax benefits and generate uncertainty with regard to investment decisions, resulting in a substantial reduction in real estate activity and an increase in future rental charges.

ACCELERATED DEPRECIATION

The Bill would reduce substantially the benefits of accelerated depreciation on real estate. New construction (other than rental housing) would not be eligible for double declining balance or sum-of-the-years'-digits method unless construction began before July 24, 1969, or a written contract for any part of the construction or for permanent financing was entered into before that date. Nonresidential new construction will now be limited to the 150 per cent method, the rate allowed under existing law for used property.

New residential construction may use accelerated depreciation only if in the taxable year at least 80 per cent of gross income from the building is from rentals of residential units.

Used buildings of whatever type which are acquired after July 24, 1969, must use straight line depreciation. The 150 per cent method of depreciation under existing law should be continued to prevent a significantly adverse effect on the resale market and on plans for new construction. The present useful life guidelines for real estate are unrealistically long and the present 150 per cent method takes cognizance of this inequity. In placing his capital, an investor must consider the ease with which he can liquidate a potential investment. Any proposal which makes it less desirable to acquire used property obviously will make it more difficult for the first owner to sell, and the initial investor will be less willing to make a real property investment.

Existing accelerated methods of depreciation should be continued for new commercial and industrial construction in order to provide incentive for continued expansion in line with our growing population. Even if an accelerated depreciation method is used, the excess over the straight line method is subject to recapture when the property is sold.

RECAPTURE OF DEPRECIATION

We do not quarrel with the concept of recapture of "excess" depreciation. However, under the proposed legislation any gain realized on depreciable real estate sold after July 24, 1969, would be recognized as ordinary income to the extent of depreciation taken after that date in excess of straight line. These rules do not only affect future acquisitions, but apply to transactions entered under the exising rules. Such legislation seems unfair and, in addition, confuses the investment community and generates too much uncertainty.

The expressed intent of these provisions is to curtail the rapid turnover of real estate investments. That purpose could be accomplished by a proposal applicable to facilities acquired after July 24, 1969, that would (1) recapture all gain as ordinary income to the extent of any depreciation claimed where the holding period is 3 years or less and (2) beginning with the first month of the fourth year reduce the percentage of gain taxed as ordinary income by 1 per cent a month. Such a provision would accomplish the intent to curtail abuse without hindering the country's need for new construction. Present law provides for a somewhat shorter recapture formula.

LIMITATIONS ON INVESTMENT INTEREST DEDUCTIONS

The Treasury on September 4, 1969, recommended to the Senate Finance Committee that this particular section of the House Bill be deleted from the legislation to be considered by the Senate. It was the feeling of the Treasury that as written, the provision failed o correct many of the problems which it was intended to deal with. It was their further feeling that it discriminates against those with earned income, and in the last analysis, may not have been necessary under any conditions due to the Allocation of Deductions provision.

We heartily agree with the recommendation of the Treasury for several reasons. Under the section as proposed, the amount of interest that would be permitted to be deducted would be restricted to essentially $25,000 for each taxpayer. The provision would apply to a partnership and to each of the individual partners. The partnership vehicle is a common one in the real estate field. From a reading of the proposed legislation and the existing Revenue Code, it is unclear whether Section 221 might apply to mortgage interest during period of construction. It probably does apply to housing which is leased to a local public housing authority under the authorization of Section 23 of the Housing Act of 1937. Under a strict reading, the Rent Supplement program of the Housing Act of 1965 is also covered since the government Rent Supplement Contract could be considered as a guarantee of income.

HOBBY LOSS MAY APPLY TO REAL ESTATE

The hobby loss provisions have been revised to apply to corporations as well as individuals, and deductions will be allowed only to the extent of gross income from *any* activity unless it is carried on with a *reasonable* expectation of realizing a profit. If there are excess deductions of $25,000 or more for any 3 of 5 consecutive taxable years, there will be a rebuttable *presumption* that there is no reasonable exception of a profit. To the mind of a sophisticated investor, this will appear to be an open invitation to tax litigation and he will avoid the possibility.

The title of this provision belies its obviousily far-reachng consequences which will hinder many bona fide business activities. For purposes of this section "activity" is defined to include a trade or business as well as an investment. The language could apply to an apartment or commercial building sustaining losses but held by the taxpayer for sale when market conditions improved or pending a decision for demolition and replacement. It would also be applicable in the early years of a properties "rent up" period as income builds up to a sustaining level.

LIMITED TAX PREFERENCES

Under this provision, if Tax Preference items exceed $10,000 and are also in excess of an individual's adjusted gross income, one-half of the excess would be taxed as ordinary income.

The items of Tax Preference included in the Bill are (1) tax exempt interest, (2) the 50 per cent deduction for long-term capital gains, (3) appreciation in the value of property donated to charity and deducted as a contribution but not included in gross income, (4) the excess of accelerated depreciation over straight line depreciation on real property and (5) farm losses to the extent they exceed losses under normal accounting rules.

Any disallowed items may be carried over and used as a deduction in the succeeding 5 years. If they are not exhausted, any remaining balance of excess real estate and farm losses would be added to the basis of capital assets only for the purpose of determining gain or loss on sale.

The LTP provisions represent an attempt to provide minimum tax on individuals. However, the House Bill and Administration recommendations skirt many so-called abuse areas and hit the real estate industry broadside. The House excluded the oil industry (percentage depletion and write-off intangible drilling costs) and the Administration wants to exempt tax exempt interest and the appreciated value of assets donated to charity. These proposals are difficult to comprehend since the tax returns of the 155 wealthy taxpayers who paid no taxes (the alleged purpose of the provisions) revealed that the greatest "loopholes" used by these taxpayers were the two which the Administration wants exempted.

As a further blow to the ability of real estate to compete for investment capital the Treasury on September 4 asked that the LTP items also include (1) interest and taxes paid by a developer during construction and (2) rapid depreciation which will be allowed taxpayers who rehabilitate housing for low and moderate income families.

Reform is needed but will not be achieved through this provision as it now exists. Today it will only serve to impede real estate development.

CONCLUSIONS

When the total effect of this legislation on real estate (depreciation methods, interest on investment property, depreciation recapture, limited tax preference and Treasury's September 4, 1969, recommendations) is considered, it is hard to relate this manifestation of Congressional intent with the announced goals of the Housing Act of 1968. Housing, while treated somewhat better than nonresidential construction, will suffer. The first owner and his investors will be in a non-liquid position due to total recapture of depreciation and the inability of their prospective buyer to use anything but straight line depreciation. The handling of construction deductions and estimating the investor's limited tax preference status is impossible to accomplish. It is safe to say that real estate will be non-competitive for the investment dollar and housing production will decline.

It should also be remembered that the cities of this Nation have invested great sums of money in their urban renewal programs. Not all of these have involved federal participation. Many of these contemplate commercial redevelopment. This development involves the reclaiming of what is by definition slum property with all the bad things that term implies. The risks of such development are even greater than in the normal situation. To deprive private industry of one avenue of profit makes the risks unreasonable and the task virtually impossible. The outlook for this type of development is even more discouraging.

Statement of Sidney I. Roberts of Roberts & Holland

PURPOSE OF STATEMENT

The purpose of this statement is to bring to the attention of the Senate Finance Committee what appears to be an omission in section 521 of H.R. 13270 as passed by the House of Representatives, and to propose an amendment that would cure that omission.

Section 521 would add a new subsection (j) to section 167 of the Code, limiting depreciation deductions in the case of real property. Paragraph (4) of section 167(j) would limit the allowance for depreciation "in the case of section 1250 property *acquired* after July 24, 1969." [Emphasis added.]

The word "acquired" might easily be read to include acquisitions, after July 24, 1969, by way of tax-free transfers under sections 332, 351, 368 and 721 of the Code, although this does not appear to have been intended.

PROPOSED AMENDMENT

In order to make it clear that such acquisitions are not to be considered under section 167(j)(4), a sentence should be added at the end of paragraph (4), substantially identical to the last sentence of section 167(j)(3), as follows:

"Under regulations prescribed by the Secretary or his delegate, rules similar to the rules provided in paragraphs (5), (9), (10), and (13) of section 48(h) shall be applied for purposes of this paragraph."

Since the same sentence would thus be duplicated in paragraphs (3) and (4), the Committee might consider it better form to delete the sentence from paragraph (3) and to create a new paragraph (5) as follows:

"Under regulations prescribed by the Secretary or his delegate, rules similar to the rules provided in paragraphs (5), (9), (10), and (13) of section 48(h) shall be applied for purposes of paragraphs (3) and (4)."

DISCUSSION

As indicated above, it does not appear that the House intended that section 167(j)(4) should apply to acquisitions in which the transferor's basis is carried over to the transferee.

Section 521(f) of H.R. 13270, amending section 381(c)(6) of the Code, provides an exception from section 167(j) for acquisitions after July 24, 1969 in transactions covered by section 381(a)—namely, liquidations under section 332 and certain reorganizations under section 368. This is accomplished by treating the transferee in those transactions as the transferor would have been treated had he retained the property. Section 381(c)(6), however, would not apply to transactions involving partnerships and other noncorporate transferees.

A similar problem arises in paragraph (3) of proposed new section 167(j), dealing with depreciation on newly constructed property, but there the House specifically provided an exception for all of the foregoing acquisitions. It directed (in the last sentence of paragraph (3)) that "rules similar to the rules provided in paragraphs (5), (9), (10), and (13) of section 48(h) shall be applied. . . ." Section 48(h) of the Code, dealing with suspension of the investment credit, provides (in subsection (h)(9)) for treating certain transferees as the transferors would have been treated. The provision covers transactions "as a result of which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731."

These provisions in new section 167(j)(3) and amended section 381(c)(6) evince an intention on the part of the House to provide a carryover of status for property acquired after July 24, 1969 in certain types of transactions. No cogent reason exists for not affording that carryover of status to noncorporate acquisitions under new section 167(j)(4).

If the legislative intention was not clearly defined during passage of the Bill by the House, then it is submitted that such carryover of status should be provided and that precedent exists in several areas under the Code.

The purpose of section 167(j)(4) as stated in the Report of the Committee on Ways and Means (H. Rept. No. 91–413 (Part 1) page 167) is to "eliminate the repeated sale and resale of property for the purpose of tax minimization." This tax minimization may be accomplished under present law by the purchase of property in a transaction in which the transferee obtains a step-up in basis, which then becomes subject to depreciation deductions in the hands of the transferee. However, an acquisition which results in a carryover of basis to the transferee does not lend itself to this abuse. Such acquisitions could be provided for by applying the rules of section 48(h)(9), perhaps being further limited to section 48(h)(9)(A)(ii). The rules of section 48(h)(10) and (13) involve situations which similarly do not appear to fall within the abuse sought to be curtailed. (The rules of section 48(h)(5) do not actually apply, but have been included above to be consistent with the language of proposed new section 167(j)(3) in H.R. 13270). Therefore, the proposed amendment would be consistent with the House's stated purpose of preventing unwarranted tax minimization.

In addition to section 48(h)(9) referred to above, which deals with the investment credit, a similar rule was adopted in section 167(i)(1) of the Code when that section was amended in 1967 to reinstate certain depreciation methods that had been temporarily suspended along with the investment credit. Section 167(i) is entitled "Limitation in Case of Property Constructed or Acquired During the Suspension Period."

Similarly, when section 1245 was enacted in 1962 and again when section 1250 was enacted in 1964, exceptions were provided "if the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731. . . ." I.C.R. §§ 1245(b)(3), 1250(d)(3).

SUMMARY

The suggested amendment is intended to provide for a carryover of status from the transferor to the transferee in certain acquisitions under proposed new section 167(j)(4). The omission of such a provision appears to have been unintentional in light of proposed new section 167(j)(3) and amended 381(c)(6), both of which would provide for such a carryover of status in similar acquisitions. The proposed amendment would be consistent with existing precedents and with the stated purpose of the House Committee on Ways and Means to prevent unwarranted tax minimization.

WEGMAN ASSOCIATES,
Tampa, Fla., August 22, 1969.

HON. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: We have just been acquainted with the provisions relating to Real Estate as contained in the Tax Reform Bill passed by the House Ways and Means Committee.

We feel that it is imperative that your attention be called to certain features of this bill which we feel will have a disastrous effect on the construction of rental apartment complexes.

Most features of this bill are reasonable, and with which the industry can survive. The two features of the bill which we consider to be disastrous for the public, and which in our opinion within twenty-four months, will produce the beginning of a social housing problem of disastrous proportions, are as follows:

1. The elimination of the 150% declining balance method of depreciation for existing apartments.

2. The classification of the accelerated portion of the depreciation as regular income on resale of the property.

In order to understand the effect of these provisions on the housing market, it is necessary to understand the events which take place to cause a developer to construct new apartments.

New rental apartments are developed by two different basic developers. One of these is the developer who builds the apartments to retain for an investment. Developers in this category are not being hampered greatly by this bill. The other source of new rental apartment construction, *who accounts for more than one-half of all starts*, is the developer who builds the project, and shortly thereafter sells it to go on to the next one, taking his profit and proceding from one complex to another. This latter developer, in our opinion, will be stopped in his tracks by this law if the 150% declining balance method of depreciation is removed from existing apartments. He will be locked in to his last completed project, as he will be unable to sell it to the investment market. This conservative investment market will not develop apartments, but only purchase existing apartments which have already been constructed, and occupied, and they won't buy unless they have reasonable tax shelter. This latter developer, in our opinion, is the one who will be the hardest hit by this bill, and is the one which *produces more new rental units than any other factor* in the construction market.

The developer who builds for investment, could live with a 150% declining balance method of depreciation and in our opinion, if the 200% declining balance method for new apartments were reduced to 150% declining balance, it would result in a Tax Reform which would be beneficial to the Government in increased revenues, and would not have a significant effect upon the development of new apartments.

We fear that if the 150% declining balance method is eliminated from the existing apartments, there will be a major social crisis on housing for families in the lower middle-income bracket, consisting of young marrieds from 20 to 35 years of age, within two years. This crisis will be something which can not be corrected in a short period of time by changing the laws again. Hindsight is not going to help the matter and it is going to be a disaster of major proportions.

Let use elucidate concerning our conclusions in this respect. There is no longer a home in the price class which can be afforded by the people in the group mentioned above. Consequently, families in this age bracket are moving into rental apartment units at a massive rate. As these new families are being formed, if the rental units are not made available, they will have no place to go. The Government subsidized low income housing will be soaked up by those in lower income brackets, and you will have a disaster for the prime movers of our economy, the prime producers of our goods, the prime sources of income tax revenue in this country, mainly the lower middle-income group. They will have no place to live.

It is only by ingenious methods, that apartments have been created for this class of citizen to rent, at a rate which he can afford. Since he can no longer afford the home until he becomes more affluent, his only resource now is the rental apartment.

We certainly hope that the Senate will do a little more investigation, and use a little more judgment than the House has shown. Tax Reform is good, and is needed, but it is not needed to be done in an irresponsible manner.

Thank you for allowing us to express our views, and we sincerely solicit your earnest consideration of these serious matters in handling this Tax Reform Bill.

Yours very truly,

W. J. WEGMAN, *Realtor*.

STATEMENT OF CHARLES DAVENPORT, DAVIS, CALIF.—AMORTIZATION OF REHABILITATION EXPENDITURES

SUMMARY

I appear in my own capacity representing no other person.

The rehabilitation of dilapidated housing structures presents a number of problems which usually renders rehabilitation an uncertain course. Rehabilitation has not been given a high priority under programs enacted by Congress.

The provisions of H.R. 13270 which permit certain rehabilitation expenditures to be amortized over 60 months have no rational relation to the solving of the rehabilitation problems—except to the extent that the allowance would constitute a subsidy and hence distribute Federal funds (through the deferral of taxes on currently earned income) to some rehabilitators. The amount distributed to any taxpayer depends on his tax rate and other income sources and pays greater rewards to high bracket taxpayers. This is contrary to our progressive tax system.

There is also no evidence that the tax benefit would not be wasted or that the funds distributed through this provision could not be more effectively applied in other programs. Also there is no evidence that the expenditure of such funds will in fact increase the housing stock.

The provision is unproven and questionable housing policy. It is unsound tax policy. It funds at the back door activities which have not gained sufficient Congressional approval for direct funding. The provision thus fails to meet the test that is generally applied to tax incentives: Is this the best way to do it? It should thus be eliminated from H.R. 13270.

STATEMENT

My name is Charles Davenport. I teach Federal income tax law at the School of Law, University of California, Davis, California. In presenting this statement I represent no interest other than my own, and I appear solely as a citizen having a special knowledge of the income tax law. From 1960 until the spring of 1967, I practiced law with a large firm in San Francisco, California, which represented many real estate investors and owners. From the spring of 1967 until just last month, I was with the Office of Tax Legislative Counsel in the Treasury Department. During my time there I had the opportunity to consider many of the tax aspects of real estate investment. I participated in the preparation of the study on real estate taxation which appears in "Tax Reform Studies and Proposals," published by this Committee and the House Committee on Ways and Means on February 5, 1969.

In addition to my interest in Federal income taxation, I am convinced that the most pressing and urgent problem now facing this nation is the housing of its people. One need only to walk through the squalor of the slums to recognize that there is a substantial number of people in this coutry who are living in substandard housing and in overcrowded conditions. The rural scene is often no better. These intolerable living conditions, when combined with the many other problems we face, tends only to aggravate them. The race problem, the pollution problem, the noise problem, the poverty problem, and many others are only made worse by the inability of substantial numbers of people to find adequate shelter. The lack of adequate shelter is intimately wound up with all of these other problems, and I submit that we will not do very well in solving them unless we find some way to provide decent shelter for our people. The reverse is also true. If we find some way to provide proper housing for our people, some of these other problems will be lessened or perhaps eliminated.

The facts and figures on the housing problem are not encouraging. While there are approximately 70 million housing units in this country, over 7 million are classified as substandard units which house some 20 million people. Of this 7 million substandard units, some 4 million lack indoor plumbing and over 3 million are considered dilapidated. We are building somewhere near 1.6 million units a year, but over the next ten years there will be a need for 26 million units, 10 million more than will be constructed at the present rate.

The picture is bleak, and the Federal funds allocated to housing have not met the need. However, the very scarcity of Federal funds to accomplish this task also argues that none of them be invested in ventures where the pay off for each dollar of Federal expenditures will be low. This is particularly true where the program has other serious drawbacks. Thus, even though the housing of our people is the most crucial and pressing problem of our time, and even though rennovation of some existing units may be appropriate, I urge this Committee not to waste any of our precious public resources upon those provisions contained in § 521(a) of H.R. 13270 which would add § 167(k) to the Internal Revenue Code to permit an amortization allowance for rehabilitation expenditures.

THE PROBLEM OF REHABILITATION

A number of problems block a very active rehabilitation industry. These are dealt with in part 4 of "A Decent Home" published by the President's Committee on Urban Housing. While they are discussed at length there, it may be well at least to summarize them at this point. They are:

(a) *Uncertainty.*—There are a number of uncertainties in rehabilitation which do not exist in new housing. One cannot be sure of the condition of the basic structural components or that the estimated cost of rehabilitation will be fairly accurate. A rule of thumb suggested by an elderly gentleman who had done considerable rehabilitation work during his life was to make as reasonable and close an estimate as possible and then to double it. These uncertainties also require a specialized construction talent with the result that most of the so-called rehabilitators are relatively small, individualized business operations. These talents are in short supply.

(b) *The Neighborhood Problem.*—Many candidates for rehabilitation are in a so-called slum area. If each of the buildings in the area were rehabilitated, the collective increase in their value might well exceed the aggregate amount spent on their rehabilitation. However, the expenditure on any one structure in the area increases its value very little because it remains in a slum. It might be possible to assemble large areas for rehabilitation, but our housing programs have not done so.

(c) *Financing.*—Both of the prior problems lead to difficulties with financing. Since cost estimates are not certain, lending institutions are reluctant to make commitments on them. In addition, many lending institutions have policies of not lending on properties in depressed areas. Recently, FHA has made some special efforts to extend its guarantees of loans to the sort of thing which would have been held to have been too risky by prior standards. Financing of the rehabilitation cost may also be complicated by the existence of financing on the purchase price of the basic structure and the land. In some, but not all, cases the two financings can be combined into a single transaction. Finally, a lending institution may well require a higher portion of equity of the overall cost of the basic structure and rehabilitation than is required for new construction because even after rehabilitation, the structure may well be an old building in a slum neighborhood.

(d) *Tenant Resistance.*—Since rehabilitation necessarily means an additional investment of capital, it seems likely that the rent levels in the building will have to rise. Thus, existing tenants are likely to oppose the rehabilitation because they probably are living at the limits of their income for housing in any event. Thus, to them, rehabilitation means only higher rents or being homeless. In many cases, the higher rent level will convert what might be classed as low income units to the luxury category.

(e) *Property Taxes.*—In the usual case property taxes will be substantially increased by rehabilitation. While the same is true for new construction, the problem for rehabilitation is somewhat aggravated because it generally also results in a large upward reassessment of the basic property value as well as the addition made through the rehabilitation.

(f) *Income Tax.*—The charge is sometimes made that the Internal Revenue Service in administering the depreciation allowance will lengthen the life of a rehabilitated structure so as to make the life somewhat unrealistic. In my own experience, this has not been much of a problem.

These may not be the only problems connected with rehabilitation, but I think that most people would agree that the foregoing touches the major problems. With these problems in mind it is interesting to note that neither the Congressional committees which deal with the housing problems nor the Department of Housing and Urban Development has shown much interest in establishing a rehabilitation program which could complete in terms of public subsidy with programs for new housing. While most of the Federal programs providing some sort of mortgage assistance are nominally available for rehabilitation, the major source of publicly assisted rehabilitation funds has been a special rehabilitation program under § 312 of the Housing Act of 1964. It authorized HUD to assist in the granting of loans at an interest rate of 3%, limited to the cost of the rehabilitation, but not in excess of $10,000 per dwelling unit, with a maximum maturity of 20 years or three-quarters of the life after rehabilitation, whichever is less. Use of this type of rehabilitation loan is also limited to Federally assisted urban renewal and concentrated code enforcement projects, certified areas, and properties which require rehabilitation to qualify under the riot reinsurance program. With these limitations on property location, and the income of applicants (so as to qualify under § 221(d)(3) of the National Housing Act), and the loan limitations, the § 312 program likely will not contribute significantly to the rehabilitation of existing housing.

All of this suggests to me that rehabilitation, while clearly desirable in many cases, may not be a high priority matter when viewed by those Congressional committees and administrative agencies most intimately involved with the housing problem.

AMORTIZATION PROVISIONS OF H.R. 13270

With this background we can now turn to the provisions of H.R. 13270 which would add § 167(k) to the Internal Revenue Code. That section would permit a taxpayer to amortize over a 60 month period expenditures made in connection with the rehabilitation of an existing building for low cost rental housing. Such expenditures would have to exceed $3,000 over two consecutive tax years, and any amount in excess of $15,000 per rental unit would not be subject to the special amortization provision. They would also have to be for the acquisition of property having a useful life in excess of five years and could not include the acquisition cost of the building or the land. Sale of the property, however, results in the recapture as ordinary income of all amortization taken to the extent it exceeds straight line depreciation.

It should be noted that this provision does nothing more than permit an amortization of expenses which would otherwise have to be capitalized and written off over a much longer period of time. The benefit conferred is that of permitting taxes on other income to be deferred through the overstatement of deductions during the amortization period. These deferred taxes are then repaid in the following years when income is overstated because there is no depreciation allowance. The deferred taxes are the equivalent of an interest free loan which is repaid in installments in subsequent years.

It is possible to quantify this benefit if certain assumptions are made. The table which follows assumes an amortization of rehabilitation expenditures over a five year period on two assumptions. The first is that the normal life of the expenditures would be ten years, and the second is that the normal life would be twenty years. It also assumes that the taxpayer who undertakes this rehabilitation expenditure could earn alternatively 8%, and then 10%, on his capital if it were invested in another endeavor. The benefit of this amortization may then be stated as the equivalent of an investment credit of some percentage of the rehabilitation cost. Alternatively, it is stated as the equivalent reduction in interest rate on a 100% mortgage at an 8% interest rate for the life of the rehabilitation expenditures assuming deductibility of interest.

VALUE OF AMORTIZATION AS PERCENT OF CAPITAL COST-INVESTMENT CREDIT EQUIVALENTS

Bracket of taxpayer, discount rate, and normal life	Amortization over 5 years	Reduction in interest of 8-percent mortgage for entire rehabilitation cost: 1 point	5 points
70-percent taxpayers:			
8-percent discount rate:			
20 years	17.1	2.4	15.4
10 years	6.8	1.4	8.1
10-percent discount rate:			
20 years	19.1	2.4	15.4
10 years	7.8	1.4	8.1
50-percent taxpayer:			
8-percent discount rate:			
20 years	12.2	4.0	25.8
10 years	4.8	2.3	13.3
10-percent discount rate:			
20 years	13.6	4.0	25.8
10 years	5.6	2.3	1.33
20-percent taxpayer:			
8-percent discount rate:			
20 years	4.8	6.3	41.2
10 years	1.9	3.7	21.7
10-percent discount rate:			
20 years	5.5	6.3	41.2
10 years	2.2	3.7	41.2

From this table one can observe:

(*a*) The value of the amortization incentive depends on the taxpayer's tax rate bracket. A five year write-off of rehabilitation expenditures that would otherwise have had a twenty year life is about a 19% investment credit for a 70% taxpayer and a 5% investment credit for a small property owner in the 20% bracket. This is the equivalent of reducing the interest rate for the 70% taxpayer by approximately 5 points, or down to 3%, and for the 20% taxpayer by 1 point, or down to 7%.

(*b*) A five year amortization period provides more incentive for rehabilitation expenditures which would have had a longer useful life under normal depreciation. In general, it may be that the longer useful life is associated with a good or extensive rehabilitation job or with a very good building shell. A short useful life would normally be associated with a very old shell or a minimum rehabilitation job or on a site which is likely to go commercial fairly soon.

(*c*) Since the amortization is keyed to rehabilitation expenditures, it has greater value to the rehabilitation where such expenditures are the greater portion of the total cost than it does where the basic structure and land costs are greater.

One concludes then the provision would offer the greatest subsidy to a high bracket taxpayer making a long lived rehabilitation that represents a very high proportion of the cost. The housing policy behind a provision which structures a subsidy so as to be most attractive to this kind of a taxpayer for this kind of rehabilitation is not apparent because there is no obvious relation between the encouraging of such rehabilitation and the housing shortage. Whether it encourages the right kind of rehabilitation, we do not know. On the other hand, it is indefensible as a matter of tax policy because it is contrary to the progressive tax system. Thus, we know the provision is bad tax policy. We really have no idea whether it is good housing policy.

IMPACT ON REHABILITATION

The effect of all this would have on the rehabilitation process is at best risky to predict. A generalization or two might be in order, however.

(a) The largest part of real estate investment is by individuals or syndicates, which pass the depreciation deduction through to their members to be used against the individual tax. A subsidy based on fast write-off works like any deduction incentive. It provides an incentive that increases with the effective tax rate of the taxpayer. Economically, such an incentive would work by attracting new resources to the favored industry until the increase in the capital supply reduced the before tax rate of return enough to restore the prior equilibrium between supply and demand. If this equilibrium were reached for, say, a taxpayer having a marginal tax rate of 50%, all investors with higher marginal tax rates would have a windfall in that the tax benefit is greater than the price change. Investors with lower tax rates would find rehabilitation less attractive than before. Two consequences seem to flow from this conclusion. First, the tax benefit is wasted in the windfall to high bracket taxpayers. Second, the high bracket investor is attracted to rehabilitation while the low bracket taxpayer or tax exempt institution is driven out. Certainly, the first of these results is not justifiable, and the second does not seem to serve any purpose. Indeed, it may be considered harmful because it could exclude non-profit organizations whose orientation is appropriate for undertaking some of the problems connected with low cost rental housing.

(b) Because the tax subsidy is available to all comers, we cannot be sure that is induces any rehabilitation that would not otherwise have been undertaken. To the extent the subsidy goes to those who would have made the rehabilitation without the subsidy, the funds lost through the amortization are wasted.

(c) Rehabilitation outlays increase the housing inventory less than does new construction (unless either (1) the rehabilitation prevents demolition or (2) the new construction is accomplished through demolition). Increased rehabilitation may also divert construction workers from new construction to a less productive (in terms of units created) form of work.

(d) Very likely funds diverted to rehabilitation will largely be funds which would have been invested in real estate anyway. Thus, if the investment funds diverted to rehabilitation do not yield more units than new construction would, the subsidy provided by the amortization is wasted and does not produce any benefit.

(e) The budget cost of the amortization allowance is estimated to commence $15 million per year and rise to $330 million. If these same funds were used to reduce the interest cost of funds borrowed for low cost housing, the interest rate could be reduced 1% on $33 billon of mortage debt. Assuming that the debt/equity ratios of such properties were 9 to 1, the total cost of such properties would exceed $36 billion, which at $20,000 per unit is 1.8 million housing units. Thus, the amortization subsidy could reduce the interest cost of 1.8 million units by 1%, on .9 million units by 2%, or on .6 million units by 3%. If this revenue loss were so used under programs now on the books, we would be sure the subsidy would flow through to the tenant. We have no assurance that the amortization provision will lower rents or otherwise benefit tenants.

CONCLUSION

Enactment of the amortization of rehabilitation expenditure is undesirable. The provision is (a) unwise tax policy and (b) uncertain housing policy.

(a) The provision is not appropriate policy for a bill which is styled a tax reform act because it has a highly preferential effect for high income taxpayers. It adds another loophole to a Code already shot full of loopholes and perverts the progressive tax system to a regressive one.

One is both amused and befuddled by a bill which gives an incentive for certain activities but takes the subsidy away through recapture on sale. The sale is argued to be an appropriate time to take something which the taxpayer should never have had. While recapture does not do this (because it still confers on the taxpayer the benefit of having deferred his taxes until sale), it can have no other justification. Better policy is to deny the benefit initially.

Similarly, the Administration's recommendation that amortization be included in the Limit on Tax Preferences indicates the true nature of this allowance. Inclusion in LTP concedes the deduction is improper and offers unwarranted benefits to high bracket taxpayers.

(b) The provision is very questionable housing policy. We are not sure that it would generate the kind of rehabilitation we need or desire. It would exclude certain segments of the housing industry (the low bracket or tax exempt taxpayer) from the rehabilitation process. There is much doubt that the funds spent through the amortization allowance will increase the housing inventory as much as a more direct subsidy. There is no suggestion that the subsidy will lower rents. This, of course, contrasts with our other subsidized housing programs. A large part of the subsidy will be wasted and may not encourage rehabilitation which would not have occurred without the subsidy. The subsidy may be spent on activities which would have taken place anyway. Finally, the Congressional committees which have designed elaborate subsidy programs for new construction have been unwilling to design programs as elaborate for rehabilitation. It seems likely that this reluctance arises out of the desire to apportion scarce Federal funds to an area in which the most pay-off can be achieved. Since the committees charged with this responsibility have chosen to allocate little to rehabilitation, it seems inappropriate for amendments to the Internal Revenue Code to fund at the back door a program which has not been admitted at the front door, particularly when there has been a general consensus that the back door route will not be used unless it is proven more efficient. On that ground alone this provision must fail.

In short, beyond the emotional nostalgia of preserving some fine old structures built in yesteryear (recently constructed but dilapidated housing seems not to have any such appeal), there is no justification for the amortization allowance. It creates another tax haven for the high income taxpayer while having a vague and unknown impact on the housing problem. Thus, it creates a loophole questioning the integrity of our progressive tax system, while flailing wildly around the housing shortage. This provision would only proliferate tax shelters while embarking on a questionable, expensive, and perhaps wholly ineffective housing policy. Scarce Federal funds can be better used through programs and appropriations more finely and rationally structured to overcome the problems of our housing shortage.

Statement of Robert L. Lanham, Vice President and Controller, American Natural Gas Service Company

The following comments with respect to the Tax Reform Act of 1969 are submitted on behalf of American Natural Gas Company ("American Natural") and its several subsidiaries. American Natural's subsidiaries are primarily engaged in the transportation and distribution of natural gas, directly or indirectly, to approximately two million customers. In addition, through one of its subsidiaries, American Natural is engaged in the rental of low and moderate income housing.

Several provisions of H.R. 13270 would have a direct impact upon the American Natural system. However, I would like to limit my detailed comments to two sections of the Bill; Section 521 of the Bill, dealing with depreciation of real estate, and Section 704 of the Bill, dealing with rapid amortization of pollution control facilities.

DEPRECIATION OF REAL ESTATE

In 1968, one of American Natural's subsidiaries began constructing low and moderate income housing. This construction was undertaken in a separate subsidiary which qualifies as a limited dividend corporation under the National Housing Act. As such, the dividends payable by the housing subsidiary are limited to 6% per annum on equity investment. Maximum rentals for housing constructed by such a corporation are fixed by the Federal Housing Administration, which must also pass on the feasibility of the project.

The first project, which involves 130 units in Detroit, Michigan, is scheduled for completion in the fall of this year. Two additional projects are now moving forward; a 134 unit townhouse-type project in a predominately Negro suburb of Detroit, and a 168 unit project for elderly and handicapped persons. Several other projects are in the planning stages.

Because of the restraints imposed by the non-tax laws on rental income and dividends, the economic feasibility of these housing projects is dependent on the continuation of those provisions of the Code which permit (1) accelerated depreciation, (2) capital gain treatment with respect to gain realized when the properties are sold after a substantial period of time, and (3) the use of 150% declining balance depreciation by the purchaser of used rental housing.

The Ways and Means Committee recognized the special need for tax incentives for the construction of housing, particularly low income housing. For example, the House Bill would continue to allow accelerated depreciation in the case of most residential housing units and would permit rapid amortization of certain expenditures incurred to rehabilitate buildings used for low income housing. However, the distinction between residential buildings and other types of structures was not applied to the proposals relating to the recapture of accelerated depreciation or the provisions which would prevent a purchaser of a used building from using the 150% declining balance.

The proposals contained in H.R. 13270, as applied to rental housing units, would decrease the amount which an owner would be able to realize upon the disposition of his property. Limiting the purchaser to straight line depreciation, the amount which a potential purchaser would be willing to pay for a used building would be decreased. By changing the recapture provisions on rental property held for more than ten years, the after-tax proceeds from the sale would be decreased, thus further reducing the financial benefits from investing in residential housing.

While it may be that the tax incentive provided under existing law with respect to commercial real estate are inappropriate, the elimination of these incentives from residential rental properties in general, and low and moderate income housing in particular, would certainly discourage taxpayers from making low-return, high-risk investments in low income housing. The decrease in the supply of such housing which would surely follow the enactment of these provisions would be a high price to pay for the small revenue gain which would result. In fact, the revenue gain will probably be substantially less than the additional funds which the Federal government will be called upon to expend to increase the supply of residential buildings which private parties are willing to construct under the existing law.

In order to keep the tax law consistent with the announced National policy of encouraging the construction and operation of low and moderate income housing, the gain which a limited dividend corporation realizes from the sale of low and moderate income dwelling units should be excluded from the proposed recapture of accelerated depreciation. Similarly, the use of 150% declining balance depreciation on used property should continue to be permitted with respect to qualified purchasers of low and moderate income dwelling units from limited dividend corporations when such purchases occur after the seller has owned the assets for a substantial period of time. In light of the nature of the assets involved and the type of taxpayer to which such relief would be limited, these changes would create no possibility for abuse.

AMORTIZATION OF POLLUTION CONTROL FACILITIES

Section 704 of the Bill proposes a new Code section which would permit the cost of certified air and water pollution control facilities to be amortized over a period of 60 months. The definition of a "certified pollution control facility" would limit the property eligible for amortization to assets which control pollution "by removing, altering, disposing, or storing pollutants, contaminants, wastes or heat . . ."

Although probably not intended by the drafters, it would appear that the language of the Bill could be interpreted in a manner which would exclude from the category of assets which qualify for rapid amortization those assets which prevent pollution by eliminating or reducing the creation of pollutants.

The Clean Air Act makes it clear that the Federal government is committed not only to the control, but also to the prevention, of air pollution. Accordingly, taxpayers should be encouraged to install facilities, such as natural gas burning equipment, that prevent pollution by eliminating or reducing the creation of pollutants.

In order to provide the same incentives to *eliminate* pollutants as the House Bill presently grants to assets that *control* pollutants, it is suggested that the definition of a "certified pollution control facility" be amended to include facilities that eliminate or reduce the creation of pollutants. Inasmuch as the provisions of Section 704 of the Bill require Federal or State certification of facilities as a prerequisite for rapid amortization, the proposed change would create no possibility for abuse.

OTHER PROVISIONS OF THE BILL

American Natural believes that certain changes should also be made to other sections of H.R. 13270, particularly Section 451 of the Bill, dealing with depreciation of utility property, and Section 501 of the Bill, relating to natural resources. American Natural fully supports the position on these issues set forth in the statement and testimony presented before this Committee on October 1, 1969 by Mr. Walter E. Rogers, President, Independent Natural Gas Association of America.

STATEMENT OF NATHANIEL S. KEITH, PRESIDENT OF THE NATIONAL HOUSING CONFERENCE

I welcome this opportunity to present the comments of the National Housing Conference on some of the proposals contained in "The Tax Reform Act of 1969." The National Housing Conference has long supported and helped to achieve many of the housing programs we have today. A common theme of all these programs has been to maximize private participation while also achieving rents within the means of those unable to afford unsubsidized housing. We believe, however, that many of these proposed changes in the House-passed Tax Bill will have serious and deleterious effects on the ability to adequately meet our critical housing shortages.

In this regard, the National Housing Conference recognizes the overriding public need for maintaining a financially sound and healthy construction industry. Without such a resource, our Nation will be able to meet the unprecedented target need of providing 26 million dwelling units during the next ten years, the goal set by the Housing and Urban Development Act of 1968. This housing is urgently needed not only to provide decent shelter and homes for people in the United States, but also to help solve the pressing social problems inherent in our ghettos and blighted neighborhoods. Unless a solution is found to the housing needs of families of low and moderate incomes, the social and economic problems of our cities are likely to prove insurmountable. The proposed tax legislation will effectively preclude the achievement of national housing goals. In an effort to realize a more "equal distribution" of the tax burden, the proposed modifications in the tax law have made private investment in real estate, particularly residential housing, even more unattractive than it is now. Unless relief is given from provisions of the House Bill, it is difficult to imagine how the national housing goals will ever be achieved.

The National Housing Conference suggests the following changes in the proposed tax reform legislation in order to assist in achieving the national housing goals:

1. The options of an investor deducting interest paid and real estate taxes paid as a current business expense during the period that the project is being built should not be limited or circumscribed. Unless such deductions are permitted as current tax deductions available to investors, the investment in real estate becomes much less attractive. This is particularly true in the case of housing to serve the needs of low and moderate income families with financing under some government-insured or assisted program. The limited return available to investors in such cases (most such programs limit the return to 6 percent) is such that it would be highly doubtful that an investment of this kind would be attractive if the investor were not permitted to deduct interest and real estate taxes during construction. This same consideration is also applicable to other presently permissible deductible items during the construction period.

2. Under the House Bill, accelerated depreciation on residential rental property is only available to the first user. This would seriously impair the resale market for rental properties and correspondingly reduce the attractiveness of initial equity investments in such properties. The NHC urges that the provisions of existing tax law as to depreciation advantages for subsequent purchasers of residential rental properties be continued. This proposed requirement in the House Bill also involves difficult applications in specific cases and introduces uncertainties which could discourage investors from investing in multifamily housing projects. If accelerated depreciation is available to the Mortgagor at the time the first family moves in, this could take place at a time long before the project is "officially" completed. Customarily, on sizeable projects partial occupancy will occur as individual buildings are completed. Yet, changes in the requirements may necessitate further investment by additional investors. In some cases, some of the original investors may die or retire and new investors substituted. In such instances, the question could be raised as to whether the mortgagor is no longer a first user entitled to depreciation.

NHC recommends that the determination of first user should occur as of the date of completion of the project. This would present no problem in the case of projects to serve the needs of low and moderate income families because under Federally-assisted financing, the government agency makes a formal determination as of the date of completion of the project. Changes in the composition of the mortgagor entity prior to that date should not preclude the availability of accelerated depreciation; indeed, changes in the composition of the entity (e.g., the death of a partner or the transfer of a limited partnership interest) after the project is completed should not be deemed a change in the first user so as to preclude the availability of accelerated depreciation.

It is doubtful that any legislative language is necessary to accomplish this result; a statement of policy in the report of the Bill will probably be sufficient to assure that there will be no arbitrary denial of the accelerated depreciation by some rigid, inflexible application of a first user principle.

3. NHC supports the provisions of the Bill which allow accelerated depreciation (double declining balance) in the case of housing developments. Denial of accelerated depreciation would require substantial increase in rents and yet yield to the investor to make an investment in housing projects financially attractive. In the case of projects to serve low and moderate income families, the alternative of increased rent would simply defeat the basic purpose of the project or require a commensurate increase in the Federal subsidy to make the investment attractive and competitive.

The best and easiest approach is simply to permit a rapid depreciation which would afford tax deductions which, in combination with cash yield, would make the project attractive to investors. This is essential to assure adequate investment in residential construction.

4. The tax advantage of accelerated depreciation would largely be lost if the proposed recapture provisions become law. Generally, since 1964, the gain on a

sale of a building is taxed as ordinary income to the extent of depreciation taken on that building after December 31, 1963. However, after the building has been held 12 months, only the excess over straight line depreciation is "recaptured." After 20 months, that amount can be reduced at the rate of 1 percent per month, until 120 months, after which nothing is recaptured. In other words, currently under section 1250, the recapture upon sale of the project is reduced on a formula scale over a period of 10 years.

Under the House Bill, the taxability of the difference between the straight line accelerated depreciation is not reduced but is recaptured regardless of when the project is sold. The effect of this provision is to negate the benefit of the deduction originally received by the taxpayer. Therefore, while the taxpayer will derive tax benefits through accelerated depreciation of the project, these will be taken away when he later sells the project. This means that the investment becomes much less attractive, since every investor will take into account the consequences of the sale of the project at some later date. It is unreasonable to assume that a requirement making the future sale of an investment unattractive will not have a debilitating effect on such investment. Even if the investor had no intention of selling the project, he must assume what the tax consequences would be in case of foreclosures where the project is in trouble. Under the proposed legislation, the foreclosure could precipitate a substantial tax to the taxpayer.

NHC recognizes, however, that the intent of the House bill was undoubtedly to avoid abuses from quick turnover projects. Hence, the NHC supports a recapture provision under Section 1250 which precludes capital gain treatment on transfers during the first 5 years and then applies a formula of 1 percent per month reduction thereafter. This would put off full capital gain treatment for over 13 years.

5. NHC believes that in the case of low and moderate income housing, the recapture provisions should not be made applicable where such housing is sold to a cooperative approved by the Secretary. There is a strong public policy embodied in the Housing and Urban Development Act of 1968 of encouraging and promoting the achievement of homeownership by families of low and moderate incomes. Cooperative ownership gives families a greater sense of responsibility and produces better communities than rental housing. NHC recommends that the recapture provision should not apply where a project owned by a limited distribution mortgagor with appropriate government-assisted financing is sold to a nonprofit cooperative consisting of low and moderate income families which will own and operate the development.

6. NHC is also concerned about the proposed tax treatment of state and local bond interest. NHC is distressed with the near collapse of the municipal bond market as a result of the House-passed provisions of H.R. 13270 which affect municipal bond interest. Since H.R. 13270 was passed, interest rates on all municipal bonds have increased an average of nearly one percentage point. Active investors in these bonds, now reacting to the uncertainty caused by the provisions on H.R. 13270, are refraining from further purchaee.

For those who have worked long and hard to help create a sound financial base for public housing, we are particularly concerned by the events of two weeks ago partially brought on by the House bill. On September 24, the Housing Assistance Administration placed nearly $192 million worth of public housing bonds on the market. These bonds are general obligations of local housing agencies and are guaranteed with the full faith and credit of the United States, a factor which gives them a triple "A" rating in the market. Because of a legal 6 percent interest ceiling, $142.4 million of these bonds failed to find bidders. Of the $49 million that did sell, a historically high interest rate of 5.9948 percent annually will be paid.

This is an intolerable situation which substantially increases the cost of public housing and threatens the future of our public housing programs. NHC joins with the National League of Cities and the United States Conference of Mayors in asking this Committee to delete any reference to interest from state and local government bonds wherever it appears in Sections 301, 302, 601 and 602 of the bill.

NATIONAL HOUSING CONFERENCE

PROPOSED LANGUAGE FOR COMMITTEE REPORT

1. Because of the tax bill may limit accelerated depreciation on residential housing to the first user, the National Housing Conference (NHC) urges that the Committee Report contain the following clarifying language carefully defining "original use" treatment (p. 301, 1, 16 and 302, 1. 22).

"Determination of 'original use' for purposes of determining eligibility under Section 167(j)(2) and (3)

"Customarily, on large projects, partial occupancy will occur as individual buildings are completed. Yet, other buildings will still be under construction and there will be other changes in the construction requirements which may necessitate further investment by additional investors. In some cases, some of the original investors may die or retire, with new investors being substituted. In such instances, the question could be raised as to whether the mortgagor is no longer an original user entitled to accelerated depreciation.

"The determination of original use should occur as of the date of completion of the project. In low and moderate income housing built under federally-assisted financing, the formal determination of the date of completion of the project is already made by the governmental agency administering the program. Changes in the composition of the mortgagor entity prior to that date should not preclude the availability of accelerated depreciation. Likewise, certain changes in the composition of the entity (e.g., the death of a partner or the transfer of a limited partnership interest) after the project is completed should not be deemed a change in the original use so as to preclude the availability of accelerated depreciation."

2. NHC urges the following language in the Report to make it clear that the "hobby loss" provisions do not apply to limited profit investments in publicly-assisted housing proects:

"Hobby Losses

"The proposed Section 213 of the House bill would amend Section 270 to create a rebuttable presumption that an activity was not being carried on with a reasonable expectation of profit if total deductions allowable with respect to that activity exceeded gross income from that activity by $25,000 in three of five consecutive years.

"This new provision is not intended to apply to investments in residential rental housing. Thus, in the case of investments in housing developed with Federal aids and subsidies, the income and profits are strictly limited by law to assure that the housing will reach the lower and moderate income group intended to be served. The amendment to Section 270 is not intended to apply to such properties."

3. NHC urges the following language in the Report to make it clear that the tax preference provisions are not applicable to interest, taxes and ground rents on residential rental housing:

"The Committee agrees with the Treasury Department's position that interest, taxes and ground rent should not be treated as a tax preference if the construction consisted of residential rental housing as defined in the proposed Section 167(j)(2) which is added by Section 521 of the House bill."

AMENDMENT RELATING TO APPROVED DISPOSITIONS OF PUBLICLY-ASSISTED HOUSING PROJECTS

Subchapter O of chapter 1 of the Internal Revenue Code of 1954 (relating to gain or loss on disposition of property) is amended by adding at the end thereof the following new part:

"PART X—DISPOSITIONS OF QUALIFIED HOUSING PROJECTS

"SEC. 1131. APPROVED DISPOSITIONS OF QUALIFIED HOUSING PROJECTS—

"(a) GENERAL RULE.—In the case of an approved disposition (as defined in subsection (c)) of a qualified housing project (as defined in subsection (b)),

"(1) any gain or loss recognized on such disposition shall be treated as gain or loss on the sale or exchange of property described in section 1231(b), and

"(2) gain shall be recognized only to the extent that the amount realized on such disposition exceeds the cost as determined under section 1012.

"(b) QUALIFIED HOUSING PROJECT.—For purposes of this section, the term 'qualified housing project' means buildings and other structures determined, in accordance with regulations prescribed by the Secretary of Housing and Urban Development, to have been constructed or rehabilitated pursuant to the provisions of the National Housing Act, as amended, or any other federal, state or local law of comparable purpose, primarily to provide publicly-assisted housing and related facilities for individuals or families of low and moderate income, and the land underlying or appurtenant to such buildings and other structures. The term 'publicly-assisted housing' as used in this subsection means multifamily housing receiving or eligible to receive the benefits of government assistance through below-market interest rate financing, interest reduction payments or rent supplements.

"(c) APPROVED DISPOSITION.—For purposes of this section, the term 'approved disposition' means any sale or transfer of a qualified housing project to a housing cooperative or otherwise to enable ownership for the benefit of individuals or families of low or moderate income in accordance with regulations prescribed by the Secretary of Housing and Urban Development and pursuant to the National Housing Act, as amended, or any other provision of federal, state or local law of comparable purpose.

EXPLANATION

NHC believes that in the case of low and moderate income housing, the recapture provisions should not be applicable where such housing is sold to a cooperative, or otherwise to enable ownership, as approved by the Secretary. There is a strong public policy embodied in the Housing and Urban Development Act of 1968 of encouraging and promoting the achievement of cooperative and other homeownership by families of low and moderate incomes. Such ownership gives families a greater sense of responsibility and produces better communities than rental housing.

NHC recommends the foregoing amendment in order that the recapture provision would not apply upon the sale of a project by a limited-dividend entity to enable ownership of the housing for the benefit of low and moderate income families, with appropriate government assistance. Typically, the sale would be to a nonprofit cooperative consisting of the lower income families residing in the project.

Re Proposed Amendment for Accelerated Depreciation for Publicly-Assisted Housing Projects

Section 167(j)(2) as added by Section 521(a) of the House bill is hereby amended by deleting all of the first sentence after the word "is" and inserting in lieu thereof the following (p. 301, l. 14):

"multifamily housing owned by a limited dividend entity which provides publicly-assisted housing and related facilities for individuals or families of low and moderate income which qualify under regulations prescribed by the Secretary of Housing and Urban Development to receive the benefits of government assistance through below-market interest rate financing, interest reduction payments, or rent supplements; and the original use of which commences with the taxpayer."

The NHC recommends this amendment if this Committee should decide that all "residential rental housing" should not be allowed to take accelerated depreciation. NHC supports the allowance of accelerated depreciation for publicly assisted housing whose owners are limited in the return they may receive and which is devoted to housing families of low and moderate income. Since the owners of such housing are limited to a 6% return on their investment, the accelerated depreciation is needed to attract and keep investors who develop and own such housing for low and moderate income families.

Re Proposed Alternative Amendments to Permit Exemptions from Section 1250 for Residential Rental Housing

1. Section 1250(a) as amended by Section 521(b) of the House bill (see p. 305) is amended by inserting the following between the words "property" and "is" on line 16 in the first sentence:

"(other than residential rental housing)"

OR

2. Alternatively, the NHC would urge that Section 1250(a)(1) be amended by adding the following between the words "property" and "is" in the first sentence:

"(other than multifamily housing owned by a limited dividend entity which provides publicly-assisted housing and related facilities for individuals or families of low and moderate income which qualify under regulations prescribed by the Secretary of Housing and Urban Development to receive the benefits of government assistance through below-market interest rate financing, interest reduction payments or rent supplements)".

The NHC recommends the exemption from the recapture provisions of Section 1250 of all residential rental property; or, in the alternative and at the least, the exemption of publicly-assisted projects serving the housing needs of low and moderate income families and individuals. An exemption of this kind is essential to obtain investor participation in the construction and ownership of such housing.

Re Proposed Alternative Amendments to Exempt from Limitation on Tax Preferences, the Deductions Related to Residential Rental Housing

1. Section 84(c)(1)(B), a new section of the Internal Revenue Code added by Section 301(a) of the House Bill (see page 166) is amended by inserting after the word "property" in the first sentence (line 13) the following:

"except for residential rental housing"

2. NHC alternatively recommends that, in the event the Committee does not want to exempt all residential rental housing, Section 84(c)(1)(B) be amended by inserting after the word "property" in the first sentence (line 13) a comma, and the following:

"other than multifamily housing owned by a limited dividend entity which provides publicly-assisted housing and related facilities for individuals or families of low and moderate income which qualify under regulations prescribed by the Secretary of Housing and Urban Development to receive the benefits of government assistance through below-market interest rate financing, interest reduction payments or rent supplements,".

NHC does not oppose the enactment of the general limitation of tax preferences and allocation of deductions. However, NHC supports an exemption therefrom as to residential rental housing, or in the alternative, as to limited dividend multifamily projects for low and moderate income families. Such an exemption will permit such worthy projects to attract the needed capital in a highly competitive market.

OCTOBER 17, 1969.

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

DEAR MR. CHAIRMAN: We are attaching hereto a statement setting forth our views on how the Federal Tax Reform Act of 1969, as passed by the House of Representatives, will affect urban housing and commercial property development in our cities. This letter will summarize in capsule form the principal suggestions made in that document.

First of all, we believe that it is not in the nation's interest to leave intact large loopholes in the progressive tax rate scale. The objective of achieving equal treatment under the tax laws is of critical importance to both the viability and creditability of the Internal Revenue Code. However, we are concerned that any proposed tax reform measures do not lower existing incentives for construction to a point which would seriously threaten the achievement of the housing objectives set forth in the Housing and Urban Development Act of 1968. This concern stems from two basic facts: first, private investment in housing is being seriously curtailed by rising costs and soaring interest rates; and second, the housing industry has historically been a relatively weak competitor for investment capital: as pointed out by the U.S. Conference of Mayors, the devastating reality is that "from 1961 to 1968, our gross national product grew at an annual rate of 5.2 percent, durable equipment by 9.9 percent, and investment in new plants by 7.5 percent, while growth in urban housing investment was only 0.5 percent."

After a thorough review of the bill enacted by the House we have concluded that this legislation goes so far in meeting the first objective of tax reform that it is clearly destructive to the second objective of achieving the housing goals set forth in the 1968 Act. As indicated in the brief attached hereto, the cumulative effect of the House-approved changes would reduce the yield on real estate investment by:

28% to 49% in the case of an investment in low- and moderate-income housing

21% to 37% in the case of an investment in new conventional residential housing, and

42% to 67% in the case of an investment in an office building or other commercial property.

If the office building boom is cut off, either because of a change in the existing tax rules, or further increases in the cost of money, or both, it will mean not only the elimination of the potential for more blue collar jobs in the cities, but, indeed, the elimination of already existing construction jobs.

When they were introduced, the existing pattern of tax depreciation rules affecting improved real property (including not merely the rules as to method of depreciation, but also the rules as to useful life, depreciable basis, and calculation of gain upon sale) might have been regarded as inconsistent, and not finely tuned to economic factors. However, since World War II, these rules have been an important factor in providing a flow of equity capital for construction of apartment houses and office buildings in cities across the nation.

This is not to say that the existing rules are immutable and should never be changed. Nevertheless, the foregoing factors further support an admonition made by former Treasury Secretary Fowler in submitting the last Administration's tax reform recommendations. Secretary Fowler warned that tax rules which have an important effect on the operations of an entire industry should not be changed without a careful study of the potential results of these changes on the industry and the economy.

This is particularly the case in regard to the development of residential housing and commercial buildings because here the impact is not merely on a particular industry. The effect is upon the economic well-being of our urban areas and citizens, especially those with low incomes. To serve them, a growing stream of new construction is required.

As set forth in our statement, in the past year, two Presidential commissions have made comprehensive studies of the development of urban housing. It is noteworthy that both of these commissions recommended increases rather than decreases in tax incentives for the construction of new urban housing.

Some have come before your Committee to take the essentially negative position of urging that all existing rules be retained. We do not agree. Rather, we respectfully suggest a series of changes in the House bill which we believe more fairly balance the dual objectives of tax reform and encouragement of urban investment. These changes may be summarized as follows:

1. *Low and Moderate Income Housing.*—We suggest retention of the existing tax rules with regard to low- and moderate-income housing, to wit:

A. The provision of the House bill permitting the continued use of the accelerated depreciation methods (that is, the 200% declining balance and sum of the years digits methods) with regard to new residential housing (low or moderate or otherwise) should be retained.

B. The House bill subjects the excess of accelerated depreciation over straight-line depreciation to the LTP and AOD sections. An exception to these sections should be provided for low- and moderate-income housing.

C. Under the House bill, upon a sale of real property, the full excess of accelerated depreciation over straight-line depreciation is subject to "recapture" as ordinary income to the extent of any gain. An exception to this should be provided in a case of the sale of low- or moderate-income housing.

D. The Committee should reject the Treasury's recommendation that interest and other carrying charge deductions during construction be subject to the LTP and AOD sections. In our opinion, the Treasury's recommendation is uniquely discriminatory; it is the sole case in which a business expenditure is arbitrarily subjected to these limitations.

(Without the modifications suggested in B, C, and D, the laudable objective of the House bill contained in A would be seriously undermined.)

E. For purposes of these rules, low- or moderate-income housing may be very narrowly defined as housing which is financed by a HUD insured loan or under a state or local program of financial assistance for low- and moderate-income housing.

2. *Rehabilitation.*—We concur in and applaud the House recommendations authorizing a 5-year rapid amortization period as an incentive for the substantial rehabilitation of low-income housing. In addition, we urge that in order to encourage the upgrading of the nation's enormous existing inventory of older housing, a similar but less generous incentive be granted for rehabilitation expen-

ditures for other housing at least 20 years old. We recommend, therefore, that substantial improvement expenditures shall be subject to a 10-year amortization period. The new useful life should be the difference between a 40-year life (the life used for new housing) and the age of building in question, but in no event less than 10 years.

3. *Conventional Multi-family Housing.*—We recommend the following set of rules with regard to conventional residential housing:

A. The provision of the House bill permitting accelerated depreciation of new residential housing should be retained.

B. The provision of the House bill subjecting the excess of accelerated over straight-line depreciation to the LTP and AOD should be retained except that:

1. Only 25 percent of the excess shall be treated as a "preference"

2. The LTP and AOD should not apply to the accelerated depreciation deductions of a taxpayer who realizes over 60% of his gross income from the development and/or ownership of real properties. (It is our understanding that this provision is similar to the rule proposed by the Administration for oil investment.)

C. The Committee should reject the Treasury's recommendation that interest and other carrying charge deductions during construction be subject to the LTP and AOD sections.

D. The Committee should reject the provision of the House bill limiting a subsequent user of residential property to straight-line depreciation. He should be permitted to use the 150% declining balance method as under existing law.

E. In regard to the recapture of depreciation on sale, we propose that:

1. Upon a sale within the first 3 years (as opposed to the first year as under present Section 1250) all depreciation, and not merely the excess over straight-line depreciation, should be subject to recapture.

2. Upon a sale after 3 years, a percentage of the excess over straight-line depreciation should be subject to recapture as under the House bill. The percentage should decline by 1% per month so that after 11 years 4 months (as contrasted with 10 years under existing law) the entire gain will be taxable as long-term capital gain.

4. *Office Buildings and Other Commercial Property.*—The following changes are suggested in the tax treatments of office buildings and other commercial property:

A. As under existing law, the first user should be permitted to use the accelerated methods of depreciation and a subsequent user should be permitted to utilize the 150% declining balance method.

B. The provision of the House bill subjecting the excess of accelerated over straight-line depreciation to the LTP and AOD should be retained except that:

1. Only 25% of the excess should be treated as a "preference"

2. The LTP and AOD should not apply to the accelerated depreciation deductions of a taxpayer who realizes over 60% of his gross income from the development and/or ownership of real properties.

C. The Committee should reject the Treasury's recommendation that interest and other carrying charge deductions during construction be subject to the LTP and AOD sections.

D. In order to prevent an abuse of rapid depreciation by means of a quick turnover of properties, there should be stricter provisions for recapture of depreciation upon a sale than those recommended by the House. Specifically, we recommend that:

1. Upon a sale within the first three years (as opposed to the first year as under the present Section 1250 and the House bill) all depreciation—and not merely the excess over straight-line depreciation—should be subjected to recapture, and

2. Upon a sale after three years, a percentage of the total prior depreciation (and not merely the excess of straight-line depreciation as under the House bill) will be subject to recapture. This percentage will decline by 1% per month so that after 11 years and 4 months (as contrasted with 10 years under existing law), the entire gain will be taxable as long-term capital gain.

We believe that these recommendations are most comprehensive and deserve your attention and evaluation. We will be glad to answer any questions you have, or to work with the staff of the Senate Finance Committee is clarifying any of these proposals.

In conclusion it is our belief that if changes are made in the Tax Reform Act of 1969 along the lines recommended herein, a measurable and desirable degree of tax reform can be brought about without serious restraints on the important objective of encouraging private investment in housing and commercial construction which is so important to the economic and social well-being of American cities.

Respectfully submitted,

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STATEMENT REGARDING HOUSING AND COMMERCIAL DEVELOPMENT PROVISIONS OF TAX REFORM BILL OF 1969 [1]

This statement represents our views on how the Federal Tax Reform Act of 1969 will affect urban housing and commercial property development in our core cities.

Our nation faces an urban crisis and one of the most conspicuous components in this crisis is the lack of safe, decent housing for many of our urban residents.

We know that over 6 million families now live in unsafe and unsanitary conditions.

We know that our housing stock continues to deteriorate at a fast rate.

We know that neither the government nor the building industry has done enough to: (1) replace the inadequate housing, and (2) slow down the rate of deterioration.

Last year, in enacting the Housing and Urban Development Act of 1968, Congress reaffirmed the goal of a "decent home and suitable living environment for every American family." Furthermore, this goal is to be . . . "substantially achieved within the next decade by the construction or rehabilitation of 26 million housing units, 6 million of these for low- and moderate income families."

In this Act, Congress strengthened existing programs and established a series of new ones to give communities and private businesses the tools they need to rehabilitate or build 26 million units. We now have a variety of government tools to encourage housing construction such as rent subsidies, interest subsidies, loan guarantees, mortgage insurance, direct loans, and below-market mortgage loans. Yet these tools are useless if private enterprise is unwilling to invest in and build housing and generally support the building industry. Private-sector participation depends on the potential returns offered by this kind of investment relative to other investment possibilities. In other words, if the rates of return in housing construction and ownership are favorable, the private sector will be more inclined to use the government tools established by last year's legislation. However, if the returns from other investments look more promising, then the goal of 26 million units in the next 10 years is not attainable and the rate of deterioration within the existing stock will increase; urban blight will continue and the urban crisis will intensify.

Inflation and tight money have seriously damaged the mortgage market and resulted in a construction slowdown. Thus, investors are placing available funds in other short-term, safer, high-yield investment areas and bypassing the longer term construction area. On September 23, 1969, George Romney, Secretary of Housing and Urban Development, disclosed that housing starts have declined by 33 percent since the beginning of the year and deemed the outlook "critical."

Dr. Leon Keyserling testifed before both this committee and the House Ways and Means Committee that, between 1960 and 1969, the construction industry has grown at a far slower rate than other forms of business investment (House Ways and Means Committee, *Hearings on Tax Reform—1969*, p. 2719).

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[1] This statement was prepared by: Gerald P. Hillman, McKinsey & Company, Inc., Robert P. O'Block, Harvard Business School, Stephen S. Zeigler, Esq., of Young, Kaplan & Edelstein.

We feel that, as the Committee examine the 1969 Tax Reform Act, you should consider all proposed changes that would affect rates of return and capital committed to the construction industry in light of the industry's already weak competitive position.

If this Committee recommends changing the tax law, and Congress approves, thereby reducing the potential yield from investing in construction, this industry will become even less attractive to private investors than before. Thus, new housing and commercial construction would be even further curtailed; and this will have an adverse effect on our entire economy. However, perhaps its most important effect would be to increase the shortage of housing and therefore increase group tensions in our major cities. The severe shortage of multifamily housing in our major cities may be illustrated with reference to the present situation in New York City.

I. HOUSING CRISIS IN NEW YORK CITY

At present, New York City is experiencing a severe shortage in housing for all income groups, and this shortage has developed in spite of one of the largest government programs for public and publicly assisted housing in the country.

The problem is that the private sector has been reluctant to build in the City for a variety of reasons, one of the most important being that alternative investments are more attractive. The following table shows the recent decline in new construction starts.

TABLE 1.—PLANS FILED AND UNITS COMPLETED FOR NEW RESIDENTIAL CONSTRUCTION,[1] NEW YORK CITY, 1959 TO 1968

Number of housing units Year	Plans filed	Completions
1959	62,700	37,200
1960	43,100	35,200
1961	150,000	35,100
1962	6,600	47,300
1963	4,200	60,000
1964	13,700	51,900
1965	20,500	49,500
1966	26,100	32,000
1967	12,200	23,000
1968 (9 months)	15,000	15,000

[1] The large increase in construction in the middle 1960's was in part the result of changes in the zoning law (note "Plans Filed" in 1961). Yet, the present rate of construction is only ½ that achieved in the late 1950's.

Rental housing has been particularly hard hit from 1965 to 1968, and the number of rental units on the market decreased by 23,000. This in turn has led to increases in rent and has produced an incredibly tight housing market, with a vacancy rate of only 1.23 percent. For tenants who live in non-rent-controlled apartments, rent increases last year averaged 26.5 percent, or $45.40 per month. Because of these exhorbitant increases, the City was forced to limit increases in noncontrolled apartments. The housing crisis is not limited to low-income groups; in fact, most noncontrolled apartments are rented to middle- and upper-income people. Thus, every New York City family feels the effect of this housing shortage.

Moreover, the rental housing is old and in generally poor condition:

> Nearly a million units now occupied were constructed before 1929, and most of these are concentrated in the slums and deteriorating neighborhoods of Brooklyn and Manhattan.
>
> About 25 percent of all units now occupied are in either deteriorated or dilapidated condition.

The condition of vacant units is even worse: Only 56.7 percent of these are sound, and 30 percent are considered to be deteriorating.

One housing expert concluded that New York City must build 45,000 units and rehabilitate 16,000 units annually over a 20-year period to replace the estimated 385,000 substandard units, to upgrade the 6,000 units which each year fall into the substandard category, and to provide for an increase of 600,000 households.[1]

To restate the obvious: New York City needs a massive housing construction and rehabilitation program. To fulfill this need, the resources of the private marketplace must be marshaled. Implicit is the notion that investments by the private market in this area must be competitive with other investment opportunities. Should changes in the Internal Revenue Code be made which limit the rate of return to these investors, we must then rely only on publicly funded programs, which means either a limited housing construction program and further deterioration, or a tremendous increase in the public sector's involvement in housing and a concomitant increase in appropriations necessary to achieve this construction.

II. THE NATURE AND EFFECT OF THE PROPOSED CHANGES

The existing depreciation rules (together with the leverage provided by a high mortgage and the normal bunching of interest deductions in the early years) generally produce the following pattern of taxability for a person building and operating residential or commercial structures:

> Generally, during the first few years of building operation, the cash flow is tax free. In addition, the owner realizes a tax loss equal to the excess of the accelerated depreciation and interest deductions over the net operating income of the property.
>
> Thereafter, for a period of several years, no tax losses are realized. However, a substantial portion of the cash flow from the property is realized by the owner, tax free.
>
> During the latter years of building operation, the pattern reverses and the owner is taxable each year on an amount of income from the property, which is greater than the cash flow he may actually draw down. (See U.S. Treasury Department, *Statement Regarding Real Estate Tax Shelters*, hearings on the President's 1963 Tax Message, p. 420.)

Inasmuch as a dollar received after 1 year is worth more than a dollar received after, say, 10 years, this pattern of initial tax losses, and later taxable income, tends to increase the potential yield of an investment in real property. (Slitor, *The Federal Income Tax in Relation to Housing*, report to President's Commission on Urban Problems, pp. 46–47.)

As set forth below, the House bill would seriously and adversely affect this pattern of tax incentives for the development of housing. The important provisions in this regard are as follows:

> At present, the first user of residential housing may utilize the "accelerated methods" of depreciation, that is, the 200 percent declining balance ("DB") and the sum of the years digits ("SYD") methods of depreciation. The House bill permits the continued use of this method for residential housing (Proposal 167, (j) (2)). However, the taxpayer's deductions for the excess of the accelerated depreciation taken over straight-line ("SL") depreciation are subject to disallowance under the limit on tax preference ("LTP") and the allocation of deductions ("AOD") sections (Prop. 84,277).[2]

Under existing law, the first user of an office building (or other commercial property) may utilize the accelerated methods of depreciation. Under the House Bill, the first user may use only the 150 percent declining-balance method, which

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[1] Dr. Frank Kristof, formerly Assistant Administrator for Programs and Policy for the Housing and Development Administration, *The Future of Rehabilitation in Our Aging Cities* (Conference of The New England Region on Problems of a Mature Economy, November 18, 1967).

[2] Under the LTP, a taxpayer's deductions (or income exclusions) for certain items (designated as "preferences") are disallowed to the extent that they exceed 50 percent of the sum of: (1) the individual's adjusted gross income, plus (2) the amount of the preferences. Among the "preferences" designated in the House Bill is the excess of accelerated over straight-line depreciation.

The designation of one of the taxpayer's deductions as a "preference" may also result in disallowance of a portion of the taxpayer's personal deductions. Under the AOD section, a taxpayer's personal deductions must be allocated between the portions of his adjusted gross income (before preferences) which are, and are not, sheltered by preferences. This calculation is made after the LTP has been applied to disallow part of the preferences. The portion of the personal deductions allocated to income sheltered by preferences is disallowed.

From the point of view of a potential investor in real estate, the AOD section is merely disallowing an additional portion of his accelerated depreciation, deducted over and above that which is disallowed under the LTP section. That is, his personal deductions would be allowed, if he did not make the investment which produced the preference.

is less rapid than the accelerated methods (i.e., the 200 percent DB and SYD methods), but more rapid than the SL method (Prop. 167(j)(1)).

At present, a subsequent user of residential or commercial real property may utilize the 150 percent DB method of depreciation, not the accelerated methods.

Under existing law, the first user of an office building (or other commercial property) may utilize the accelerated methods of depreciation. Under the House Bill, the first user may use only the 150 percent declining-balance method, which is less rapid than the accelerated methods (i.e., the 200 percent DB and SYD methods), but more rapid than the SL method (Prop. 167(j)(1)).

At present, a subsequent user of residential or commercial real property may utilize the 150 percent DB method of depreciation, not the accelerated methods. Under the House Bill, a subsequent user may use only SL depreciation (Prop. 167(j)(4)).

At present, under Section 1250 of the Internal Revenue Code, upon a sale of real property (residential or commercial), only a limited portion of prior depreciation taken by the taxpayer may be subject to "recapture" (i.e., treatment as ordinary income to the extent of any gain realized). Specifically, if the taxpayer has held the property for over 12 months, only the excess of the accelerated depreciation taken over SL depreciation is subject to recapture. The percentage of this excess subject to recapture declines by 1 percent for each month that the taxpayer has held the property for over 20 months. Thus, after 10 years, no part of the gain realized on a sale is subject to ordinary income treatment.

Under the House bill, the entire excess of the accelerated depreciation taken over SL depreciation is subject to recapture upon a sale, no matter when the sale is made, that is, the sliding scale has been eliminated. The Treasury has now proposed an exemption to the stricter recapture rule upon a sale of low- and moderate-income housing financed by a loan insured by HUD.

For conventional residential housing, in the hands of the first user, the Treasury subsequently proposed full recapture of excess depreciation for the first 10 years, lowered by 1 percent per month to year 19 of the taxpayer's holding period, when all gain realized on a sale is taxed as long-term capital gain (*Technical Explanation of Treasury*, p. 43).

Under present law, a taxpayer may deduct currently (rather than capitalize) interest and real estate taxes paid during the construction period.

Under the House bill, such carrying charge deductions are not subject to the LTP or AOD.[3]

The Treasury has proposed to the Committee, however, a more rigid treatment, namely, subjecting the taxpayer's carrying charge deductions to the LTP in regard to commercial but not residential property (*Statement of Treasury Secretary David M. Kennedy*, September 4, 1969, p. 37; *Technical Memorandum of the Treasury*, p. 19).

The House bill did include one provision allowing greater liberality in depreciation of real property. It permits a taxpayer making significant rehabilitation expenditures in regard to low-income housing to amortize such expenditures over a period of 5 years. The maximum expenditure thus amortizable is $15,000 per unit. In order to be eligible for this rapid amortization, the taxpayer must expend over $3,000 per unit in a period of 2 consecutive pears (Prop. 167 (r)).

The Treasury suggested to your Committee that there be subjected to the LTP the excess of amortization taken under this provision over the depreciation allowable under the otherwise applicable life (Statement of Secretary Kennedy, *supra*).

We have recently made calculations to determine the effect that the proposed changes in the House bill would have on the yield of the builder/owner of a residential or commercial building.[4] These calculations are set forth in full in Exhibits 1 to 11 attached hereto. They may be summarized as follows:

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[3] Under the House bill, if the property will be subject to a net lease upon completion, the interest deductions may be subject to partial disallowance under the AOD section or the investment interest section. Based on discussions between New York City representatives and the staff of the Joint Committee on Internal Revenue Taxation, it appears this result may never have been intended and will be corrected at a technical level.

[4] Throughout this analysis, yield is defined as the discount rate which equals the present value of cash inflows to the present value of cash outflows. This discount rate in economic terms is commonly called the internal rate of return. Cash flows included are the initial equity investment, interest and real estate taxes during construction, before-tax cash flow, the cash value of taxable income and the after-tax capital gain.

The cumulative effect of the changes in the House bill, with the proposed Treasury changes therein (the "House changes"), is *to reduce the yield of an investment in real property by the following percentages, assuming returns under existing laws equal 100 percent:*[5]

—27.6 to 48.6 percent in the case of an investment in low- and moderate-income housing[6]

—20.9 to 37.4 percent in the case of an investment in new conventional residential housing[6]

—42.2 to 66.5 percent in the case of an investment in an office building.[6]

The effect of the provision for a greater recapture of depreciation upon sale, considered by itself, is to reduce the yield of an investment in real property by a minimum of the following percentages:

—4.9 percent in the case of an investment in low- and moderate-income housing

—2.0 percent in the case of an investment in conventional residential housing

—2.1 percent in the case of an investment in an office building.

The foregoing figures are a very low estimate of the impact of a reduction in sales price on yield, since they assume that the developer is looking forward to a depreciation in property value of 1 percent per annum. If, as is generally the case, the developer is looking forward to an appreciation in value, the stricter recapture of depreciation will have a much greater impact on the developer's expected yield, that is, a percentage yield reduction in the range of 10.0 to 13.1 percent for conventional housing and 7.2 to 10.5 percent for commercial construction.[7]

The effect of the proposed restriction of a subsequent user to straight-line depreciation, considered by itself, is to reduce the subsequent user's yield by approximately 22 percent.[8] This, in turn, reduces the selling price that the first user may expect and reduces the first user's yield by a minimum of the following percentages:

—4.6 percent in the case of an investment in low- and moderate-income housing

—4.4 percent in the case of an investment in a conventional apartment house

—5.7 percent in the case of an investment in an office building.

The figures are a very low estimate of the impact of a reduction in the first user's sales price on yield. They assume that the developer is looking forward to a depreciation in property value of 1 percent per annum. If, as is generally the case, the developer is looking forward to an appreciation in value, the limit of the second user to straight-line depreciation, which reduces the first user's sales price, will have a much greater impact on the developer's expected yield, that is, a percentage yield reduction in the range of 42.9 to 44.8 percent for conventional housing and 40.7 to 42.9 percent for commercial construction.[9]

The effect of limiting the first user of an office building to 150 percent DB depreciation, as opposed to 200 percent DB depreciation, is to reduce such user's yield by approximately 18 percent.

The effect of applying the LTP and AOD sections to construction carrying charges is to reduce the yield of an investment in real property by the following percentage:[9]

—20.0 to 34.7 percent in the case of an investment in low- and moderate-income housing[10]

—17.9 to 30.7 percent in the case of an investment in conventional residential housing[10]

—16.7 to 30.6 percent in the case of an investment in office buildings.[10]

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[5] Ranges calculated assuming 50 to 100 percent disallowance of accelerated depreciation and/or carrying charges under LTP and AOD.

[6] Percentage reductions calculated assuming returns under existing tax laws equal 100 percent.

[7] Range calculated assuming a 1 percent and 2 percent per year increase in property value.

[8] Percentage reduction for low- and moderate-income housing equals 20.5 percent; reduction for office buildings equals 22.6 percent.

[9] Ranges calculated assuming 50 to 100 percent disallowance under LTP and AOD.

[10] Percent reductions calculated assuming returns under existing tax laws equal 100 percent.

The effect of applying the LTP and AOD sections to accelerated depreciation, considered by itself, is to reduce the yield of an investment in real property by the following percentages:[11]

—27.6 to 48.6 percent in the case of an investment in low- and moderate-income housing

—20.9 to 37.4 percent in the case of an investment in conventional residential housing

—18.0 to 23.7 percent in the case of an investment in office buildings.

Clearly then, the House bill (especially the proposed Treasury revision therein) would drastically change the economics of investment in residential housing and commercial development—change it in such a way as to significantly reduce the incentive to build such structures.[11]

III. SUMMARY OF OUR POSITION

When it was introduced, the existing pattern of tax depreciation rules affecting improved real property (including not merely the rules as to method of depreciation, but also the rules as to useful life, depreciable basis, and calculation of gain upon sale) might be regarded as inconsistent, and not finely tuned to economic factors. However, since World War II, these rules have been an important factor in providing a flow of equity capital for construction of apartment houses and office buildings in cities across the nation. (Slitor, supra, p. 45; *1969 House Hearings*, pp. 2656–57 (testimony of representative of National Association of Real Estate Boards), p. 2753 (testimony of representative of National Apartment Association), pp. 2776–77 (testimony of representative of Mortgage Bankers Association of America).) Thus, for example, in hearings on the Revenue Act of 1964, the Treasury submitted exhibits showing that the existing tax advantages were a major factor in inducing the public to invest in public real estate development companies. (See *Statement on Real Estate Tax Shelters*, hearings on the President's 1963 Tax Message, p. 420.) The following chart included in the 1969 Hearings tells the story better than many statements.

This is not to say that the existing rules are immutable and should never be changed. Nevertheless, the foregoing factors further support an admonition made by former Treasury Secretary Fowler in submitting the last Administration's tax reform recommendations. Secretary Fowler warned that tax rules which have an important effect on the operations of an entire industry should not be changed without a careful study of the potential results of these changes on the industry and the economy.

This is particularly the case in regard to the development of residential housing and commercial buildings, because here the impact is not merely on a particular industry. The effect is upon the economic well-being of our urban areas and citizens, especially those with low-incomes. To serve them, a growing stream of new construction is required. As the *Report on the President's Commission on Civil Disorders* states:

> "Today, after more than three decades of fragmented and grossly underfunded Federal housing programs, decent housing remains a chronic problem for the disadvantaged urban household. (Fifty-six percent of the country's nonwhite families live in central cities today, and of these, nearly two-thirds live in neighborhoods marked by substandard housing and general urban blight.) For these citizens, condemned by segregation and poverty to live in the decaying slums of our central cities, the goal of a decent home and suitable environment is as far distant as ever.
>
> "Statistics available for the period since 1960 indicate that the trend is continuing. (There has been virtually no decline in the number of occupied dilapidated units in metropolitan areas . . .)
>
> "Inadequate housing is not limited to Negroes. Even in the central cities the problem affects two and a half times as many white as nonwhite households. Nationally, over 4 million of the nearly 6 million occupied substandard units in 1966 were occupied by whites. . . .
>
> "Nevertheless, in the Negro ghetto, grossly inadequate housing continues to be a critical problem." (*New York Times*, ed. pp. 467–68.)

As set forth below, in the past year two Presidential commissions have made comprehensive studies of the development of urban housing. It is noteworthy

[11] Changes in yield are summarized in Exhibits 4 to 6.

that both of these commissions recommended increases rather than decreases in tax incentives for the construction of new urban housing.

We recognize that the achievement of these housing goals must be balanced with the objective of achieving a fair tax structure. However, it is our position that the House bill goes too far in meeting the tax reform objectives at the expense of the housing objectives.

With a view toward attaining a better balance between housing and tax reform goals, we have made a series of detailed recommendations relating to each of four major categories of real property, namely:

Low- and moderate-income housing
Rehabilitation of existing housing
Conventional residential housing
Office buildings and other commercial structures.

Our recommendations are summarized in the cover letter attached hereto. They are specified in the following discussions of the aspects of housing and commercial development affected.

IV. LOW- AND MODERATE-INCOME HOUSING

A. New Construction

The case for retention of at least the existing tax incentives is most clear in regard to low- and moderate-income housing.

Thus the memorandum on real estate tax changes submitted by the Treasury under the Johnson Administration (the "Treasury Memorandum") did not recommend any change in the existing depreciation rules regarding low- and moderate-income housing. In this regard, it quoted the following recommendations in the *Report of the National Commission on Urban Problems* (the "Douglas Commission"):

> "The Commission recommends prompt revision of the Federal income tax laws to provide increased incentives for investment in low and moderate income housing, relative to other real estate investment, where such housing is governmentally subsidized and involved in a legal limit upon the allowable return on investors' equity capital. Specifically, we propose that the Internal Revenue Code be amended to provide especially favorable treatment (whether preferential depreciation allowance or through investment credits) for investments made under the governmentally-aided limited-profit programs for the construction of low and moderate income housing."

Indeed, after the Treasury Memorandum was prepared, the *President's Commission on Urban Housing* (the "Kaiser Commission") issued a further report regarding the development of low- and moderate-income housing. This Report recommended not a cutback of existing tax incentives, but rather the addition of further tax incentives, that is:

> A tax credit for investment in low- and moderate-income housing comparable to the existing investment credit.[12]
>
> A partial forgiveness of capital gains tax upon certain sales of low- and moderate-income housing.

Thus, two Presidential Commissions, each working for over a year, submitted comprehensive reports recommending increases, not decreases, in the existing tax incentives for the development and operation of low- and moderate-income housing. Each report was made on the basis of studies done by leading consultants, public hearings, intensive statistical studies, and the experience of the distinguished Committee members.

The distinguished group of businessmen who constituted the Advisory Panel on Private Enterprise to the Commission on Civil Disorders recommended:

> "It is contended that tax incentives tend to obscure the search for more effective techniques to common social goals. This may be an effective argument in regard to other uses of tax incentives, but it is inapplicable to the use we recommend. We arrived at the tax approach only after carefully appraising the various other available means of governmental assistance.

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[12] As one leading economist stated: "It is, perhaps, permissible to cast a puzzled glance at national policies which purport to encourage housing as such and at the same time appear to regard private investment in housing as "unproductive" (compared with, say, investment in industrial plant) and hence unworthy of investment tax incentives." Netzer, *Housing Taxation and Housing Policy*, p. 136 (1967).

several of which have been tried. After weighing these alternatives, we have come to the firm conclusion that the tax technique is indeed the most effective for the particular social goal. We have sought a means of motivating the widest possible spectrum of American business in alleviating joblessness in our urban and rural poverty areas, and we find that no other technique is as likely to move the American business community into action for this purpose as the tax incentive device."

The fact is any substantial reduction of the existing tax incentives for the development and operation of low- and moderate-income housing would result in driving private investment out of this field. The reason why this is so is quite simple. The rents on privately owned low- and moderate-income housing qualifying for assistance under Federal or state programs are generally restricted to an amount sufficient to yield the owner a 6 percent cash flow on his net equity. In an economy in which an investor can realize an 8 or 9 percent yield on a high-grade corporate bond (or yields of 10 to 11 percent on a mortgage, that is, a debt investment in real estate), a yield of 6 percent would hardly induce private parties to undertake the work and risk involved in the development of low- and moderate-income housing.

The difficulties which tend to discourage builders from undertaking a low-income project include:

1. Assembling land in the face of possible resistance from militant community groups
2. Inducing investors to contribute "seed money" for attorneys' and architects' fees and land deposits before final government authorization for the project has been obtained
3. Estimating construction costs and the construction period—especially if, as is often necessary, some inexperienced new subcontractors are used
4. Meeting government cost limitations
5. Obtaining government approval for rent increases when such increases become necessary due to increased expenses
6. Dealing with rent interruptions and possible rent strikes—both of which may be totally unrelated to the operations of the particular project
7. Delegating certain management responsibilities to a tenant's group which, at least at the outset, will probably be inexperienced in real estate management.

The 1968 Housing and Urban Development Act provides a new interest subsidy program to reduce the rental charges of housing erected by private enterprise under Federal, state, and local loan programs. In addition, this same legislation established a new mechanism—a National Housing Partnership (the "NHP")—which will use existing tax incentives to attract new capital to the housing market. The NHP will be a private partnership in which the equity interests will be held by the nation's leading industrial concerns. The NHP will, in turn, purchase up to 25 percent equity interests in low- and moderate-income housing projects sponsored by local partnerships. It was the hope of Congress that existing tax incentives, together with certain provisions of the new Act, would be sufficient to raise the yield of investments in low- and moderate-income housing to those realized by leading industrial corporations. Thus, the *Senate Report* stated:

"The partnership arrangement also makes it possible to assure an adequate return to investors. Under existing Internal Revenue Service regulations and rulings, partnership losses for tax purposes flow to the individual partners. In the case of new housing units financed on a 10 percent equity-90 percent debt basis, the annual accelerated depreciation of the building costs results in substantial book losses during the initial 10 years after the project is built. Assuming the member of the partnership is in a relatively high income bracket, his share of the depreciation losses plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capital." (*S. Rep. No. 1123*, 90th Cong. 2d Sess. p. 85 (1968).)

The NHP organization arose as a result of a proposal by the Kaiser Commission. In hearings before the House Ways and Means Committee on this tax reform bill, Mr. Kaiser stated:

"Private participation in the development of housing for low- and moderate-income families depends upon the continued availability of assistance through both the Federal housing programs and existing Federal income tax treatment of real estate. Changes in existing rules regarding accelerated methods of depreciation could make equity investment in low- and moderate-income housing less attractive and reduce private participation in housing.

"Increased private involvement in producing decent housing for the poor in the volume required could not be expected if either of the existing incentives is eliminated without providing suitable substitutes.

"Even if substitutes for the tax incentives were designed, housing production may slow down until the new programs are proven and become familiar to the industry.

"The existing combination of Federal assistance and favorable tax treatment have not succeeded in producing sufficient amounts of housing for low- and moderate-income families. Instead of eliminating existing incentives, additional devices for stimulating the production of low- and moderate-income housing should be provided." (*1969 Hearings*, p. 2797.)

Thus the case for not cutting back the existing benefits in regard to privately financed low- and moderate-income housing is quite basic—without them, the rate of private construction of low- and moderate-income housing will be severely curtailed.

There are some who state, regardless of what existing tax rules are for low- and moderate-income housing, that little private construction will be undertaken. We respectfully dissent from this position.

In 1968, the New York State legislature amended the Mitchell-Lama Law[13] to allow a partnership to be the sponsor of a project financed thereunder. The purpose of this amendment was to spur investor and builder interest in the development of low- and middle-income housing by making available the pass-through of tax losses which the partnership form accords. The effect of this amendment dramatically indicates the impact of tax incentives on the development of low- and moderate-income housing.

In May 1969, New York City held a public forum on private investment in low- and moderate-income housing, which was well attended. Leading attorneys and representatives of the investment banking and building communities reported on the effect of the Mitchell-Lama amendment.

Thereafter, in June 1969, New York City made its first loan to a partnership and since that time, three other projects have gone to loan closings and construction in the partnership format, representing a total of over 1,000 new units. The application for these projects, filed years before, had been dormant until the use of the partnership form was authorized. It is noteworthy that the sponsors of each project applied for interest-reduction payments under Section 236 of the National Housing Act (added by the 1968 Housing Act), so that apartments could be rented to the very lowest income families. At the present time, applications covering thousands of additional units employing the partnership format are in the administrative pipeline.

All of these endeavors may be curtailed by the House Bill, since, as set forth above, the cumulative effect is to reduce the yield of an investment in low-come housing by a striking 27.6 to 48.6 percent. Moreover, as indicated by the material in Exhibits 1 to 11 attached hereto, the impact in yields of any one of these changes, considered separately, is significant.

In view of the high risk and work factors involved in developing low-income housing, two Presidential commissions recommended increased tax incentives for low- and moderate-income housing to attract private investment, not tax disincentives. Hence, we take the position that at the very least, no change should be made in the existing tax rules affecting low- and moderate-income housing.

The Treasury's offer to surrender the increased recapture on the sale of a limited category of low- and moderate-income projects is of no consequence because, of all the changes proposed, increased recapture has the least effect—only a 4.9 percent reduction in yield.[14] Even with this change excluded, the cumulative effect of the House changes is to reduce the yield of an investment in low- and moderate-income housing by 22.7 to 43.7 percent.

Indeed the Treasury's proposal apparently covers only projects financed by loans insured by HUD under Section 221 (d) or Section 236 of the National Housing Act. It does not even cover low- and moderate-income projects financed by State or local low-interest-rate loans.

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[13] The New York State Private Housing Finance Law, Article II (commonly called the "Mitchell-Lama Law") authorizes the City and the State Housing Finance Agency to make long-term, low-interest-rate loans to private sponsors of low- and middle-income housing projects and to grant local real estate abatement to such projects.

[14] Calculation based on a sales price reduction of 1 percent per annum.

A separate point should be made of our recommendation that accelerated depreciation of low- and moderate-income housing be exempted from the LTP and AOD.[15] We do not denigrate the importance of the LTP and the AOD as the "goal-line" defenses against a taxpayer, eliminating an undue portion of his taxable income by various preferences. Nor do we dispute that as to a potential investor without any other preferences and without major personal deductions, these two rules have little, if any, effect. However, these observations are of only theoretical significance since the typical investor in a low- or moderate-income housing project is a wealthy individual who has other substantial preferences. To such an individual, the application of the LTP and AOD means, in essence, a potential disallowance of from 50 to 100 percent of his deductions for accelerated depreciation deductions; and as set forth above, the combined effect of such disallowances (considered apart from the other House changes) is to reduce his yield from investment in the project by about 27.6 to 48.6 percent. Needless to say, if such an individual has other activities (e.g., oil and security investments), producing tax preferences in excess of the 50 percent limit, the activity that he will first seek to eliminate (or not undertake at all) is an investment in low- or moderate-income housing—simply because such an investment does not yield a substantial income apart from the tax savings.

Of equal importance to the economic impact of the LTP and AOD is their psychological effect. We are informed that since passage of the House bill, developers of low- and moderate-income housing projects have faced even greater difficulties than before in securing equity investments. Prospective investors, counseled by their accountants and lawyers, have been "turned off" by the complexity of the LTP and AOD and the difficulty of predicting the economic impact for the investment time horizon. Of course, such factors do not constitute a valid argument against some application of LTP and AOD to depreciation (e.g., of an office building), where economic factors rather than tax savings should predominate in determining whether the investment is made. However, these factors militate against applying the LTP and AOD to an investment in low- and moderate-income housing where under government regulations the cash flow from rentals is not competitive and hence the tax incentives are critical.

Finally, it is an undeniable fact that granting preferential treatment to low- and moderate-income housing in the form of exclusion from the LTP and AOD will greatly increase the number of investors interested in such projects.

In summary, *we suggest retention of all the existing tax rules with regard to low- and moderate-income housing,* to wit:

1. The provision of the House bill permitting the continued use of the accelerated depreciation methods (that is, the 200 percent declining balance and sum of the years digits methods) with regard to new residential housing (low- or moderate-income or otherwise) should be retained.
2. The House bill subjects the excess of accelerated depreciation over straight-line depreciation to the LTP and AOD sections. An exception to these sections should be provided for low- and moderate-income housing.
3. Under the House bill, upon a sale of real property, the full excess of accelerated depreciation over straight-line depreciation is subject to "recapture" as ordinary income to the extent of any gain. An exception to this (or any stricter recapture role) should be provided in a case of the sale of low- or moderate-income housing.[16]

In the 1968 Housing Act, Congress authorized HUD to insure a 100 percent mortgage loan to a cooperative or nonprofit organization to purchase a project from its initial limited-dividend sponsor. This provision was an important bridge between the private developer, who eventually wishes to secure a return of the capital invested in the project, and the community, which wishes to secure management rights in the project.

A postponement of gain provision, such as that discussed above, would provide a further incentive toward reaching the goal of private development with eventual community ownership. The provision should be narrowly limited to the situation in which the taxpayer reinvests the proceeds of the sale in yet

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[15] For reasons set forth below, we take the position that construction interest and other carrying charges should in no case be subject to the LTP and AOD.

[16] Indeed, the Committee might consider granting full nonrecognition of gain treatment upon a sale of a low- or moderate-income project when:

(a) The sale is made to a cooperative or local nonprofit organization.

(b) The taxpayer reinvests an amount equal to the net proceeds of the sale in another low- or moderate-incme project.

another low- or moderate-income project. It will be noted that the *President's Commission on Urban Housing* recommended exemption of gain on a sale to a cooperative or nonprofit buyer without any reinvestment requirement.

4. For purposes of these rules, low- or moderate-income housing may be very narrowly defined as housing which is financed by a HUD-insured loan or under a state or local program of assistance for low- and moderate-income housing.

No loss of revenue for the Treasury will be generated by the above proposal for low- and moderate-income residential housing (see Exhibit 7).

B. AMORTIZATION OF REHABILITATION EXPENDITURES

The House bill contains a new provision to promote the rehabilitation of low-income housing. The bill authorizes a 5-year amortization period in regard to expenditures for the rehabilitation of low-income housing, if the taxpayer makes such expenditures in excess of $3,000 per unit over a period of 2 consecutive years (including the taxable year). The maximum amount subject to the rapid amortization is $15,000 per unit.

We heartily applaud this proposal as one of the most imaginative attempts in years to spur low-income housing development.

Our awareness of the great potential of rehabilitation is indicated by the fact that New York City is currently financing a prototype rehabilitation project in Brooklyn which, upon completion, will consist of 450 units. The rehabilitation being done is of a "gut" character with nothing but the structural shells of the old buildings being retained. Thus, upon completion, the units will be virtually new. They will, however, rent at a figure of approximately two-thirds of the rentals of new low-income housing currently being developed. This project is sponsored by a limited partnership in which leading businessmen and corporations are the investors and a young, imaginative builder is the active manager. With the assistance of the new amortization provision, hundreds of such projects can be undertaken.

Completely apart, however, from this type of "development" rehabilitation, there is a need to remove the tax detriments to the current rehabilitation of all types of older housing, low-, moderate-, and high-income. In many of our urban areas at the present time, the deterioration of the existing housing inventory is taking place at such a rapid rate that even the most ambitious development program could never hope to catch up. A leading expert has suggested that in the next few years, 47,000 buildings in New York City will be abandoned (Dr. Frank S. Kristof, Statement at Meeting of American Statistical Association August 20, 1968).

We do not believe that a new tax incentive is necessary to encourage this type of rehabilitation, because outside of the low-income areas, rehabilitation should and will produce its own economic return. However, we feel that it is necessary to remove at least the present tax deterrents to the rehabilitation of older housing.

At present, the very fact of a substantial rehabilitation expenditure is sometimes used by an IRS agent as evidence that the useful life of the property is longer than that claimed by the taxpayer in his return. "If not, why did he make the expenditure?" Needless to say, the *possibility* of this result has a deterrent effect on the owner's considering the expenditure.

The uncertainty is greater because, unlike the case in regard to new housing, the Treasury guidelines do not specify any particular life for used housing acquired by the taxpayer. The "guideline life" for new residential housing is 40 years. However, if a taxpayer purchases a building, say, 25 years old, the regulations do not explicitly authorize him to use a 15-year life.

We believe that the making of rehabilitation expenditures would be facilitated if their tax consequences were more predictable. Specifically, we recommend that when a taxpayer makes rehabilitation expenditures meeting the requirements hereinafter set forth, he should be permitted upon completion of the work, to establish a new useful life for his entire adjusted basis in the building in question. The new useful life should be the difference between the 40 year life for new housing and the age of the building in question, but in no event less than 10 years. This provision would be optional and the taxpayer would be free to claim faster depreciation deductions if he could substantiate them under existing rules.

The foregoing provision would apply only when:

1. The building is at least 20 years old at the time of the rehabilitation in question, and
2. The rehabilitation expenditures over a period of 2 consecutive years (including the taxable year) exceed the greater of:
   (a) $3,000 per unit
   (b) Five percent of the taxable adjusted basis for the units (excluding land cost) at the beginning of the period.

This change in the depreciable life of the building in question should accompany the authorization of a 10-year amortization period in regard to the expenditures for rehabilitation. These provisions could encourage desperately needed investment in existing housing stock, now in declining condition.

V. CONVENTIONAL MULTIFAMILY HOUSING

The case for the retention of the existing depreciation rules in regard to conventional, non-publicly-assisted multifamily housing is becoming unfortunately quite similar to the case in regard to subsidized low- and moderate-income housing.

In recent years, the costs of construction and operation of multifamily housing in center cities have increased geometrically. At the same time, as money has become increasingly tight, interest rates have also increased rapidly. The trend continues as the costs of land, labor, and money continue to rise. Land costs lead the increase at 6 percent per year, followed closely by 5 percent per year construction cost increases. (See Figures 2 to 5.)

This pattern of costs has gradually produced a situation in which new construction in our urban areas is limited to subsidized low-income units and high-income luxury apartments. The economics involved are producing a financial environment in which there is no place for the middle class in the cities.

The ramifications of this situation are startling. It will lead to further migration of the middle class to the suburbs and continued dwindling of the urban tax base. As these people are replaced by low-income families, an increased demand for services is forced upon the central city. Thus, the financial condition of cities worsens from two directions: the loss of a tax-paying middle-class base and the increased demand for more municipal services, necessitating an increased rate of city expenditure. In short, the urban housing crisis is critically linked to the financial crisis that cities are experiencing.

Without the continual construction of housing units for the middle class, we must be content to accept cities which are populated islands of affluence and poverty, witnessing both economic wealth and economic deprivation.

Thus, the housing crisis in our cities is not limited to the poor, but encompasses the middle class and the rich. We just do not have enough standard units to go around. We need a program of construction which will increase the supply of housing and simultaneously hold down rental charges.

The grim facts are that without wealthy or subsidized tenants, rentals cannot cover the estimated debt service on construction and operating costs, let alone provide the owner with an adequate yield on his investment. Thus, for example, the minimum aggregate development cost (including land, carrying charges, and construction) of a nonsubsidized 2-bedroom unit in New York City, at the present time, may be in excess of $36,000. Assuming a 90 percent mortgage payable over 30 years, the estimated monthly rental necessary simply to cover expenses is $410, computed as follows:

Debt service	$238
Operating expenses	60
Real estate taxes [17]	84
Vacancy factor (7 percent)	28
Estimated monthly rental necessary to merely cover expenses	410

[17] This tax is estimated at about 20 percent of gross rental income, a typical figure according to recent studies.

In view of these factors, construction of middle-income housing in the cities has declined rapidly.

Recent experiences in New York may be more severe than in other cities, but it is surely the direction in which other cities are heading. As set forth above, recent rent increases were so high that the City was forced to adopt a system of rent guidelines, limiting rent increases to approximately 10 percent every two years.

The relevance of the aforesaid economic pattern to the tax changes presently being considered by the Committee is obvious. If builder-investor yields are already being squeezed out of existence by the converging lines of cost increases and governmental rent controls, the reduction of existing tax incentives will bring construction to a total halt.

Thus, the Treasury's proposals will result in an economic imbalance for conventional multifamily housing similar to that which we find in low- and moderate-income housing. The rentals which society is able and willing to pay are too limited to yield an adequate rate of return for the owner. The difference between the rate of return included in rents and that necessary to induce new construction must, of necessity, come from tax incentives or *direct* government subsidies.

Obviously, such a system leaves a great deal to be desired. At least in regard to housing for the middle class, the housing industry should "be able to stand on its own." However, the fact of the matter is that in view of current construction, operating, and financing costs, the industry is unable to do so unless it charges rentals which would completely push the middle class out of the cities—a result which would seriously intensify the nation's racial crisis.

As set forth above, the changes proposed by the House bill would, both cumulatively and separately, have a drastic effect on the yield of an investment in a conventional apartment house—anywhere from a 44 to 70 percent reduction of yield on a cumulative basis. Thus, the question must be asked: In view of the facts described above regarding the desperate need for more construction of conventional apartment houses and the critical industry conditions at the present time, what, if any, justification is there for making these changes?

The report of the House Ways and Means Committee sets forth two objectives for its changes, both of which can be met without these serious effects on new housing developments.

Objective 1—The Committee asserts that the existing liberal tax depreciation rules could be abused by a quick turnover of properties ((*H.R. Rep. 91–412*) (Part I), 91st Congress, 1st Session, p. 166 (1968)). This is the apparent rationale for its denial of 150 percent DB depreciation to a subsequent user and its proposal for stricter recapture upon any sale.

Both of these provisions reduce significantly the yield of an apartment house. As set forth in Exhibits 1 to 11, the denial of 150 percent DB depreciation to a subsequent user reduces that user's yield by 20.5 to 22.6 percent.[15] Accordingly, it reduces the price he is willing to pay to the developer (first owner) of the property and the developer's projected yield is accordingly reduced by a minimum of 5 to 6 percent.

For conventional residential housing, the House provision for increased recapture of depreciation reduces the developer's yield by about 5.4 to 26.2 percent in the case of a sale after about 5 years and by 2 to 9.4 percent in the case of a sale after about 12 years.

It would seem that the repeated turnover abuses could be corrected by requiring a far stricter recapture of depreciation upon an early sale. Thus, we recommended that upon a sale of a conventional apartment house within 3 years after acquisition, the entire depreciation (and not merely the excess over straight line as under the House bill) should be subject to recapture as ordinary income. Thereafter, the depreciation in excess of the straight-line rate should be subject to recapture on a sliding scale as under existing law. This complete recapture within the first 3 years would clearly prevent the turnover abuses. For example, upon sale at the end of 3 years with full recapture, the investor's yield would be

[15] Range of percentage yield reduction computed for low and moderate, conventional and commercial construction.

reduced by 26.8 percent. In addition, the Treasury would collect an additional $25,832 per $1MM of investment through the capital gains tax.

This type of interrorem recapture upon quick sales would permit Congress to correct the turnover abuse, while still: (a) leaving 150 percent DB depreciation in effect for a subsequent user, and (b) having a recapture provision which does not so severely affect an investor who holds the property for a long period of time. The yield reductions for a 12-year holding period under our proposal would be from 8.0 to 11.2 percent.

Objective 2.—The second basic objective of the House Committee was to prevent individuals from sheltering their entire incomes by real estate depreciation. This was the basis for the treatment of the excess of accelerated over straight-line depreciation as a preference under the LTP and AOD (House Report, *supra*, pp. 9, 77–78).

This proposed change has a serious effect on the yield of an investment in a conventional apartment house. Assuming a 50 percent disallowance of accelerated depreciation under the LTP and AOD, the reduction in yield is 20.9 percent. Assuming a 100 percent disallowance, the reduction in yield is 30.7 percent.

Clearly, such drastic reductions in yield would reduce still further the already declining rate of construction of apartment buildings.

While it appears, on the basis of statistics submitted to the Ways and Means Committee, that there is a need for limiting the extent to which an individual can eliminate otherwise taxable income by faster bookkeeping charges for accelerated depreciation, nevertheless this need must be balanced against the country's needs for the construction of residential housing.

In an effort to resolve this conflict of objectives, we propose that only 25 percent of the excess of accelerated over straight-line depreciation should be subject to the LTP and AOD. This proposal would serve the function of preventing individuals from reducing their tax to zero by means of accelerated depreciation. However, in contrast to the House proposal, it would reduce the yield of an investment in residential real property by only 10.5 percent, a cutback which, though harmful, should not be fatal.

This very moderate proposal should be considered in the light of the following point made to your committee by an industry representative.

> "The limit on tax preferences (LTP) was originally devised to prevent high-income persons from escaping taxation. As it has now been watered down, hobby farming may escape it by the use of accrual method of accounting; oil is exempted from it; the bulk of the income from municipal bonds is exempted; and the Treasury has recommended elimination not only of any reference to state and municipal bonds but also the appreciated value of assets donated to charity, Thus, the prime target of the limited tax preference plan now turns out to be real estate, the one area in our economy which can stand the least the cutback which would inevitably result from the provisions in the House-approved bill." (*Senate Hearings*, p. 2128.)

This point is underscored by a recommendation which the Treasury has now made to your Committee. The Treasury proposes that percentage depletion and intangible drilling expenses be included in the LTP and AOD, but that an exception be provided for an individual who derives over 60 percent of his gross income from the business. The apparent rationale for this exception is that the LTP and AOD should be used to strike only at deductions and exceptions an individual secures by investment to shelter his main business income. It should not be used to change the tax characteristics of an individual's normal business transactions. It seems very basic and important that a parallel exception should be granted to the treatment of accelerated depreciation as "a preference." The exception should apply to an individual who derives over 60 percent of his gross income from the development and ownership of real properties.

In summary, then, we recommend the following set of rules with regard to conventional residential housing (i.e., residential housing other than low- or moderate-income housing):

> The provision of the House bill permitting accelerated depreciation of new residential housing should be retained.

The provision of the House bill subjecting the excess of accelerated over straight-line depreciation to the LTP and AOD should be retained, except that:

—Only 25 percent of the excess should be treated as a "preference"

—The LTP and AOD should not apply to the accelerated depreciation deductions of a taxpayer who realizes over 60 percent of his gross income from the development and/or ownership of real properties.

The Committee should reject the Treasury's recommendation that interest and other carrying-charge deductions during construction be subject to the LTP and AOD sections.

The Committee should reject the provision of the House bill limiting a subsequent user of residential property to straight-line depreciation. He should be permitted to use the 150 percent declining balance method as under existing law.

In regard to the recapture of depreciation on sale, we propose that:

—Upon a sale within the first 3 years (as opposed to the first year as under present Section 1250) all depreciation, and not merely the excess over the straight-line depreciation, should be subject to recapture.

—Upon a sale after 3 years, only a percentage of the excess over straight-line depreciation should be subject to recapture as under the House bill. The percentage should decline by 1 percent per month, so that after 11 years and 4 months (as contrasted with 10 years under existing law) the entire gain will be taxable as long-term capital gain.

It will be noted that even with only these limited changes, there will be a decrease in the yield of an investment in conventional residential housing of 9.7 percent, assuming a sale after 5 years, and by 10.5 percent, assuming a sale after 12 years. This is clearly not an insubstantial price being paid for tax reform. Exhibits 8 and 9 compare the revenue position in regard to conventional residential housing under the House bill and our proposals.

VI. OFFICE BUILDINGS AND OTHER COMMERCIAL PROPERTY

We are also gravely concerned about the impact of the House bill upon the development in our urban areas of commercial real properties; that is, factories, warehouses, office buildings, shopping centers, and other structures. The reasons why we are concerned may be illustrated by reference to office buildings, which represent one of the primary forms of commercial construction in our urban areas.

As set forth in Exhibit 11, the effect of our proposal on conventional residential housing is to give the Treasury a full 40 percent of the revenue it might expect from the House changes.

Reams of economic literature and governmental studies have been produced in recent years about the emigration of manufacturing and wholesaling industries out from the cities to the suburbs and rural areas, and of the economic suffering produced by the departure of the blue collar jobs (see, e.g., Council of Economic Advisors, *Economic Report of the President*, pp. 134–35 (1968)). Needless to say, the impact of this departure of industry has been most serious for the Negroes and Puerto Ricans coming into the cities, since the normal route of advancement for minority groups has been from unskilled jobs to professional or white collar work. The President's Commission on Civil Disorders regarded the movement of blue-collar industry out of the cities as one of the most important reasons why the Negro and Puerto Rican groups have not moved forward in income and job standing as rapidly as previous minority groups. (*Report*, pp. 278–79.)

Office building construction is one of the few growth industries left in the center cities which utilizes skilled labor. Thus, in recent years there has been a really prodigious boom in office building construction in center cities. (See *Fortune*, October 1969, p. 184).

The tax benefits offered by the present depreciation rules have been a major factor in this office building construction boom. It is true that the actual construction work is often done by large publicly held corporations which might do the work solely for construction fees, even if the existing tax benefits of ownership were eliminated. However, these large corporations generally do not "enter the picture" until the risky and time-consuming jobs of land assembly, planning, and financing have been done by an independent entrepreneurial group. The independent group which generally emerges as an owner or co-owner of the property is generally motivated, in large part, by the significant tax benefits of the ownership interest; i.e., current deductions of carrying charges during construction and rapid depreciation deductions thereafter.

If the office building boom is cut off, either because of a change in the existing tax rules, or further increases in the most of money, or both, it will mean not only the elimination of the potential for more blue collar jobs in the cities, but, indeed the elimination of already existing construction jobs. Under prevalent union seniority rules, the first jobs to be eliminated would be those in which minority group members have been placed in recent years as a result of efforts by government, industry, and the unions themselves. Surely this tragedy should not be permitted to occur.

As indicated in Exhibits 1 to 11, in recent years investments in office buildings have been profitable as an economic matter and should be able to stand on their own without special tax incentives. Here, if anywhere, it is appropriate to apply the LTP and AOD to prevent the use of accelerated depreciation deductions to shelter an individual's entire income against tax. However, as the Treasury proposed in the use of oil depletion and drilling expenses, an exception should be granted for an individual who realizes over 60 percent of his gross income from the development and ownership of real properties.

However, we firmly believe that in other respects the House bill goes too far, and in the wrong direction, in regard to achieving tax reform for commercial construction.

In the first place, as set forth in Exhibit 6 attached hereto, the application of the LTP and AOD to construction carrying charges has an extremely serious effect on yield even in regard to otherwise profitable office buildings. It reduces the available yield by anywhere from 16.7 to 30.6 percent. Thus, to apply the LTP and AOD to construction carrying charges incurred in the development of office buildings and other commercial construction could very well have adverse effects on the economy of our urban areas, as set forth above.

Moreover, for the following reasons, the rationales for the LTP and AOD simply do not apply to construction interest and other carrying charges.

1. Carrying charges, unlike accelerated depreciation and the capital-gain deduction (i.e., the other primary LTP items), are not mere bookkeeping entries. Carrying-charge deductions represent out-of-pocket expenditures.

2. The rationale for the application of the LTP and AOD to a deduction is supposedly that the deduction bears an artificial relationship to the activity which generates it, i.e., that the taxpayer is engaging in the activity so as to generate deductions to shelter his other income (*House Report*, pp. 10–18). Hence, it is disallowed when it exceeds a certain percentage of the taxpayer's other income. Construction interest can hardly be disallowed under this rationale because, by definition, it is incurred when there is no other income from the activity to offset against it. This lack of offsetting income from the same activity is not a tax device. It merely results from the fact that when a taxpayer is constructing a building, he is not realizing any income from it.

Finally, there is a further reason why it is inappropriate to apply the LTP and AOD to construction interest in regard to office buildings and other commercial property. The group which assembles the land and arranges the financing and construction very often does not retain an ownership interest after construction has been completed. Thus, to subject construction interest to the LTP and AOD is to change the entire economic picture for the very group which makes the construction possible.

Apart from the LTP and AOD, we believe that the reforms proposed by the House in regard to depreciation of commercial properties are misdirected rather than too severe. In order to prevent the abuses of rapid depreciation deductions, the House limited the first user of commercial buildings to 150 percent DB depreciation (as opposed to the accelerated method available under existing law) and limited a subsequent user to SL depreciation (as opposed to 150 percent DB method under existing law).

The problems of depreciation policy now presented in regard to commercial real property are similar to those considered by the Treasury and Congress in 1962 in regard to commercial personal property, i.e., machinery and equipment. It was then concluded that business investment could be encouraged to the maximum extent, while at the same time preventing tax-reduction abuses, by:

Allowing initial liberal depreciation deductions with their positive effect on yield[19] while at the same time

Imposing very strict recapture of depreciation upon a sale.[20]

We respectfully submit that the same considerations apply to office and other commercial buildings.

Thus, we recommend that the Committee adopt, in regard to office buildings, the following changes:

As under existing law, the first user should be permitted to use the accelerated methods of depreciation and a subsequent user should be permitted to utilize the 150 percent declining balance method.

In order to prevent an abuse of rapid depreciation by means of a quick turnover of properties, there should be stricter provisions for recapture of depreciation upon a sale than those recommended by the House. Specifically, we recommend that:

—Upon a sale within the first 3 years (as opposed to the first year as under the present Section 1250 and the House bill), all depreciation, and not merely the excess over straight-line depreciation, should be subject to recapture; and

—Upon a sale after 3 years, a percentage of the total prior depreciation (and not merely the excess of straight-line depreciation as under the House bill) will be subject to recapture. This percentage will decline by 1 percent per month so that after 11 years and 4 months (as contrasted with 10 years under existing law), the entire gain will be taxable as long-term capital gain.

We recommend that 25 percent of the excess of accelerated over straight-line depreciation should be treated as a preference, with an exception for an individual who realizes over 60 percent of his gross income from the development and ownership of real properties. However, we recommend that the Committee reject the Treasury's suggestion that construction carrying charges be subject to LTP.

It will be noted that even with only these limited changes, there will be a decrease in the yield on investment of 8 percent, assuming a sale after 5 years, and of 11.2 percent, assuming a sale after 12 years. Exhibits 10 and 11 compare the Treasury's revenue position in regard to commercial properties under the House bill and our proposals.

We do not submit that the rules that we propose are the embodiment of wisdom. We must all be realistic enough to realize that there are two diametrically opposed objectives in competition here—the objective of securing the construction of more new housing and commercial structures in our urban areas and the objective of preventing undue tax avoidance. We believe that the House bill goes too far in meeting the second objective and will have disastrous results upon the construction of housing in our urban areas. We believe that the rules we suggest might represent a better balance between the objectives.

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[19] This was done in the depreciation guidelines promulgated by the Treasury which allowed shorter useful lives for depreciation purposes (*Rev. Proc. 62–21,* 1962–2 C.B. 418).

[20] This was done by the enactment of Section 1245.

Figure 2

LAND COSTS HAVE RISEN AT LEAST 6 PERCENT PER YEAR . . . .

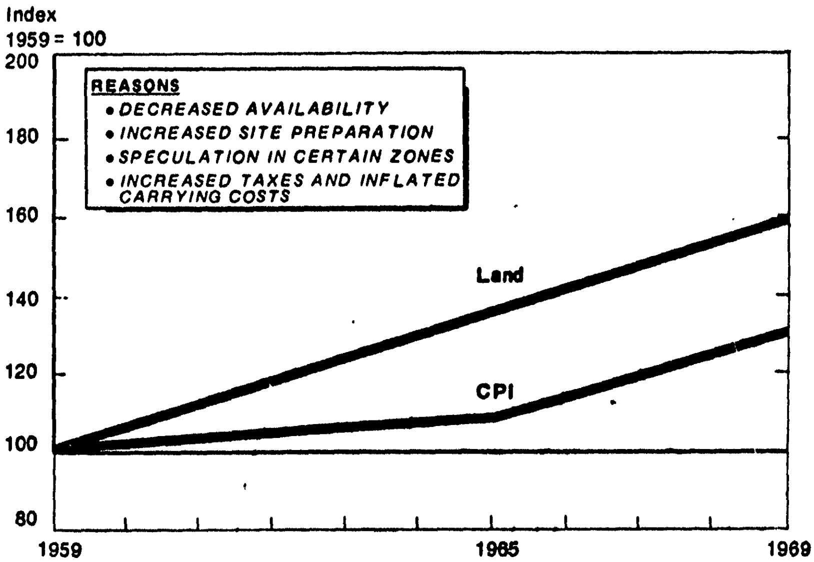
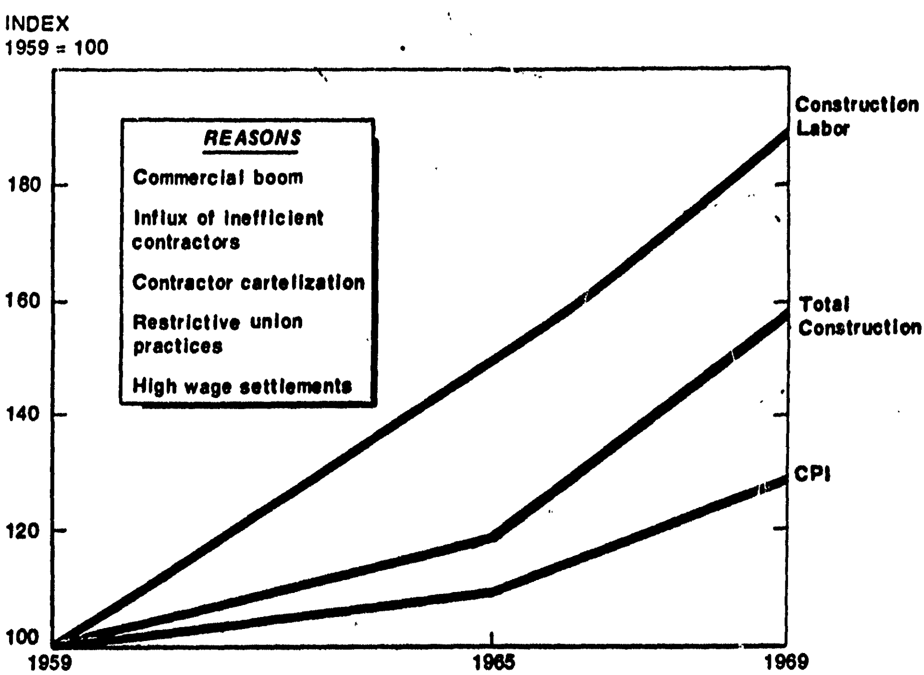


Figure 3

CONSTRUCTION COSTS HAVE RISEN 5 PERCENT PER YEAR*
LABOR HAS LED THE INCREASE . . . .



* At more than 10 percent per year for past 2 years.

Figure 4

INTEREST RATES, HAVE INCREASED DRAMATICALLY . . .
. . . AND, MULTIPLIED BY OTHER COST INCREASES, ARE SKYROCKETING DEBT SERVICE . . . .

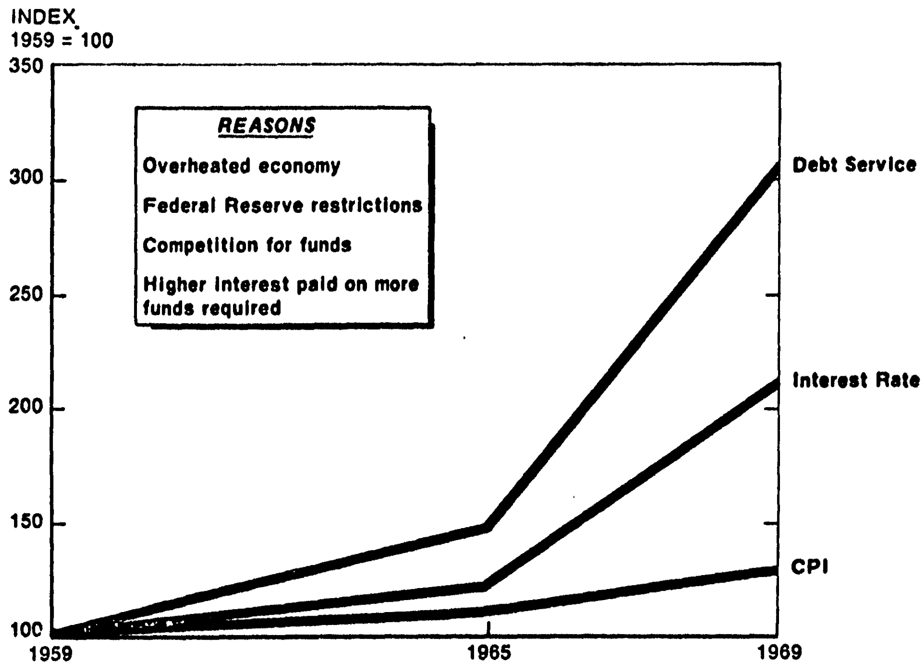


Figure 5

Operating expenses have increased for three reasons

- Labor costs
- Tenant demands
- Utilities cost

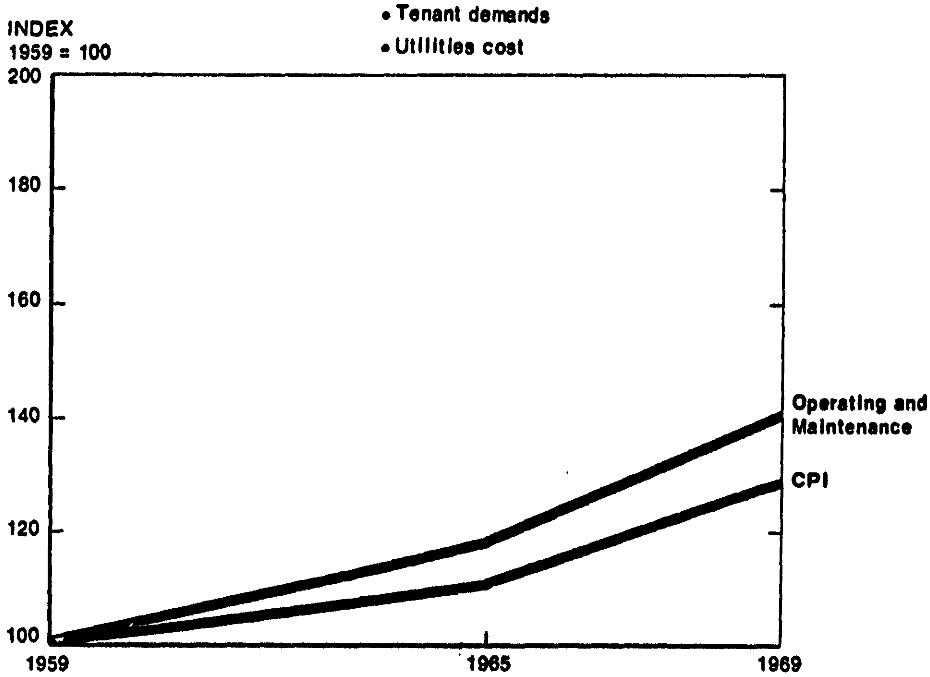


EXHIBIT 1

Assumptions used for low-and moderate-priced residential housing are as follows . . . .

	LOW-AND MODERATE-PRICED RESIDENTIAL HOUSING
Total Project Cost	$1,000,000
Construction Interest Rate	9%
Average Construction Loan	$500,000
Time Construction Loan Outstanding	1 year
Interest Charges During Construction	$45,000
Real Estate Taxes During Construction	$5,000
Land and Other Nondepreciable Items (including carrying charges)	$150,000
Depreciable Amount	$850,000
Depreciable Life	40 years
Mortgage Amount	$900,000
Permanent Mortgage Interest Rate	6.5%
Permanent Mortgage Term	40 years
Equity Investment	$100,000
Return on Equity Required	6%
Sales Price	Original Cost Less 1% per annum
DETERMINATION OF CASH FLOW	
Revenue	$200,000
Less: Operating, Maintenance and Real Estate Taxes	130,376
Yearly Debt Service	63,624
Before-Tax Operating Cash Flow	$6,000

EXHIBIT 2

Assumptions used for conventional residential housing are as follows . . . .

	CONVENTIONAL RESIDENTIAL HOUSING
Total Project Cost	$1,000,000
Construction Interest Rate	9%
Average Construction Loan	$500,000
Time Construction Loan Outstanding	1 year
Interest Charges During Construction	$45,000
Real Estate Taxes During Construction	$5,000
Land and Other Nondepreciable Items (including carrying charges)	$150,000
Depreciable Amount	$850,000
Depreciable Life	40 years
Mortgage Amount	$900,000
Permanent Mortgage Interest Rate	8.5%
Permanent Mortgage Term	40 years
Equity Investment	$100,000
Return on Equity Required	12%
Sales Price	Original Cost
DETERMINATION OF CASH FLOW	
Revenue	$250,000
Less: Operating, Maintenance and Real Estate Taxes	158,456
Yearly Debt Service	79,544
Before-Tax Operating Cash Flow	$12,000

EXHIBIT 3

Assumptions used for commercial and office building construction are as follows . . . .

	COMMERCIAL AND OFFICE BUILDING CONSTRUCTION
Total Project Cost	$1,000,000
Construction Interest Rate	9%
Average Construction Loan	$500,000
Time Construction Loan Outstanding	1 year
Interest Charges During Construction	$45,000
Real Estate Taxes During Construction	$5,000
Land and Other Nondepreciable Items (including carrying charges)	$150,000
Depreciable Amount	$850,000
Depreciable Life	50 years
Mortgage Amount	$900,000
Permanent Mortgage Interest Rate	8.5%
Permanent Mortgage Term	40 years
Equity Investment	$100,000
Return on Equity Required	18%
Sales Price	Original Cost
DETERMINATION OF CASH FLOW	
Revenue	$275,000
Less: Operating, Maintenance and Real Estate Taxes	177,456
Yearly Debt Service	79,544
Before-Tax Operating Cash Flow	$18,000

EXHIBIT 4

PROFITABILITY IN LOW-AND MODERATE-INCOME HOUSING PROJECTS IS DRASTICALLY REDUCED UNDER THE PROPOSED TAX LAW . . . .

IF ALL CHANGES ARE INCORPORATED, PROFITS WILL BE REDUCED BY 81.5 PERCENT . . . .

Return as a percentage of existing return

Percentage of Decrease in return

TAX ASSUMPTION TESTED	FULL DEDUCTION OF CONSTRUCTION CHARGES	HALF DEDUCTION OF CONSTRUCTION CHARGES	CONSTRUCTION CHARGE DEDUCTION ELIMINATED	200 PERCENT DOUBLE-DECLINING BALANCE	150 PERCENT DOUBLE-DECLINING BALANCE	STRAIGHT-LINE	EXISTING 1250 RECAPTURE	1250 RECAPTURE ELIMINATED	SALES PRICE EQUALS ORIGINAL COST LESS 1 PERCENT PER ANNUM	SALES PRICE EQUAL MORTGAGE BALANCE TIMES 1.03	CHANGE IN PROJECTED RATE OF RETURN (Existing law equals base 100): Return as a percentage of existing return	Percentage of Decrease in return
1. Existing laws	X			X			X		X		100%	
2. 100 percent disallowance LTP on all items*			X			X		X		X	18.5%	81.5%
3. 50 percent disallowance LTP on all items		X			X		X			X	47.9	52.1
4. 100 percent disallowance LTP only on construction charges			X	X			X		X		65.3	34 7
5. 50 percent disallowance LTP only on construction charges		X		X			X		X		80.0	20.0
6. 100 percent disallowance LTP to both construction charges and accelerated depreciation			X			X	X		X		31.1	68.9
7. 50 percent disallowance LTP to both construction charges and accelerated depreciation		X			X		X		X		56.9	43.1
8. 100 percent disallowance LTP to accelerated depreciation	X					X	X		X		51.4	48.6
9. 50 percent disallowance LTP to accelerated depreciation	X				X		X		X		72.4	27.6
10. Limit second user to straight-line depreciation, thereby reducing selling price of first owner	X			X			X			X	95.4	4.6
11. 100 percent recapture of accelerated over straight-line depreciation	X			X				X	X		95.1	4.9

*All references to LTP include the AOD.

EXHIBIT 5

PROFITABILITY IN CONVENTIONAL RESIDENTIAL HOUSING PROJECTS IS DRASTICALLY REDUCED UNDER THE PROPOSED TAX LAW . . . .

IF ALL CHANGES ARE INCORPORATED, PROFITS WILL BE REDUCED BY 70.1 PERCENT . . . .

Return as a percentage of existing return

Percentage of decrease in return

TAX ASSUMPTION TESTED	FULL DEDUCTION OF CONSTRUCTION CHARGES	HALF DEDUCTION OF CONSTRUCTION CHARGES	CONSTRUCTION CHARGE DEDUCTION ELIMINATED	200 PERCENT DOUBLE DECLINING BALANCE	150 PERCENT DOUBLE-DECLINING BALANCE	STRAIGHT-LINE	EXISTING 1250 RECAPTURE	1250 RECAPTURE ELIMINATED	SALE PRICE EQUAL ORIGINAL COST	SALES PRICE EQUAL MORTGAGE BALANCE TIMES 1.03	CHANGE IN PROJECTED RATE OF RETURN (Existing law equals base 100)
1. Existing laws	X			X			X		X		100%
2. 100 percent disallowance LTP on all items*			X			X		X		X	29.9% 70.1%
3. 50 percent disallowance LTP on all items		X			X		X			X	55.6 44.4
4. 100 percent disallowance LTP only on construction charges			X	X			X		X		69.3 30.7
5. 50 percent disallowance LTP only on construction charges		X		X			X		X		82.1 17.9
6. 100 percent disallowance LTP to both construction charges and accelerated depreciation			X			X	X		X		43.0 57.0
7. 50 percent disallowance LTP to both construction charges and accelerated depreciation		X			X		X		X		64.8 35.2
8. 100 percent disallowance LTP to accelerated depreciation	X					X	X		X		62.6 37.4
9. 50 percent disallowance LTP to accelerated depreciation	X				X		X		X		79.1 20.9
10. Limit second user to straight-line depreciation, thereby reducing selling price of first owner	X			X			X			X	95.6 4.4
11. 100 percent recapture of accelerated over straight-line depreciation	X			X				X	X		98.0 2.0

*All references to LTP include the AOD.

EXHIBIT 6

PROFITABILITY IN COMMERCIAL AND OFFICE BUILDING CONSTRUCTION IS DRASTICALLY REDUCED UNDER THE PROPOSED TAX LAW . . . .

IF ALL CHANGES ARE INCORPORATED, PROFITS WILL BE REDUCED BY 66.5 PERCENT . . . .

Return as a percentage of existing return (white bar)

Percentage of decrease in return (dark bar)

TAX ASSUMPTION TESTED	FULL DEDUCTION OF CONSTRUCTION CHARGES	HALF DEDUCTION OF CONSTRUCTION CHARGES	CONSTRUCTION CHARGE DEDUCTION ELIMINATED	200 PERCENT DOUBLE-DECLINING BALANCE	150 PERCENT DOUBLE-DECLINING BALANCE	STRAIGHT-LINE	EXISTING 1250 RECAPTURE	1250 RECAPTURE ELIMINATED	SALE PRICE EQUAL ORIGINAL COST	SALES PRICE EQUAL MORTGAGE BALANCE TIMES 1.03	CHANGE IN PROJECTED RATE OF RETURN (Existing law equals base 100)
1. Existing laws	X			X			X		X		100%
2. 100 percent disallowance LTP on all items*			X			X		X		X	33.5% / 66.5%
3. 50 percent disallowance LTP on all items		X			X		X			X	57.8 / 42.2
4. 100 percent disallowance LTP only on construction charges			X	X			X		X		69.4 / 30.6
5. 50 percent disallowance LTP only on construction charges		X		X			X		X		83.3 / 16.7
6. 100 percent disallowance LTP to both construction charges and accelerated depreciation			X			X	X		X		46.7 / 53.3
7. 50 percent disallowance LTP to both construction charges and accelerated depreciation		X			X		X		X		67.7 / 32.3
8. 100 percent disallowance LTP to accelerated depreciation	X					X	X		X		76.3 / 23.7
9. 50 percent disallowance LTP to accelerated depreciation	X				X		X		X		82.0 / 18.0
10. Limit second user to straight-line depreciation, thereby reducing selling price of first owner	X			X			X			X	94.3 / 5.7
11. 100 percent recapture of accelerated over straight-line depreciation	X			X				X	X		97.9 / 2.1

*All references to LTP include the AOD.

EXHIBIT 7

WE PROPOSE NO CHANGES IN THE EXISTING LAWS FOR LOW- AND MODERATE-INCOME HOUSING

(SALE IN YEAR 12)

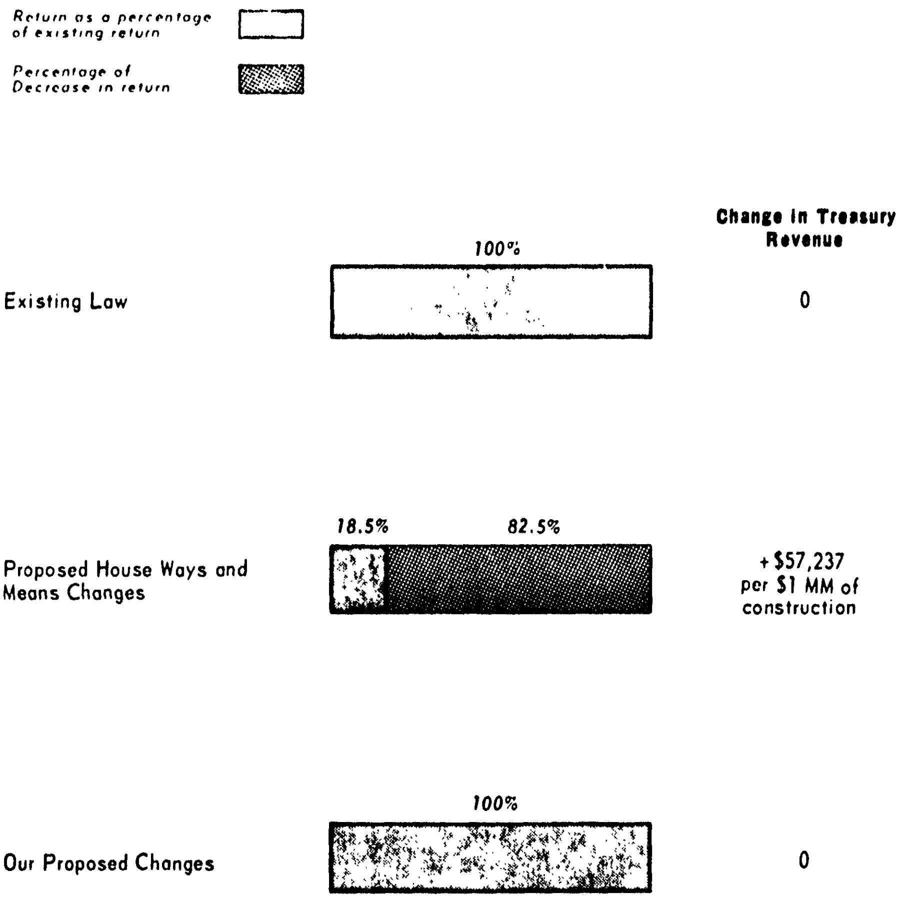


EXHIBIT 8

WE PROPOSE (1) ONLY 25 PERCENT OF THE EXCESS OF ACCELERATED OVER STRAIGHT-LINE DEPRECIATION BE SUBJECT TO LTP AND AOD AND (2) SLIDING SCALE RECAPTURE STARTING IN 36TH MONTH . . . .

CONVENTIONAL RESIDENTIAL HOUSING

(SALE IN YEAR 5)

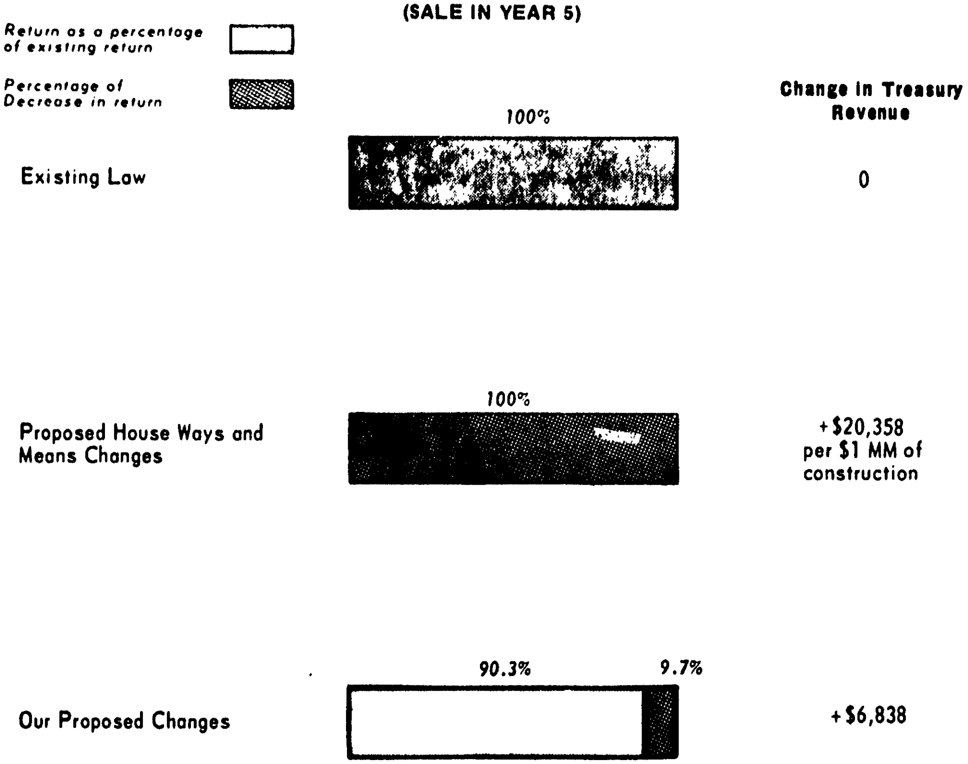


EXHIBIT 9

WE PROPOSE (1) ONLY 25 PERCENT OF THE EXCESS OF ACCELERATED OVER STRAIGHT-LINE DEPRECIATION BE SUBJECT TO LTP AND AOD, AND (2) SLIDING SCALE RECAPTURE STARTING IN 36TH MONTH; OUR PROPOSALS GIVE THE TREASURY APPROXIMATELY 50 PERCENT OF THE REVENUE IT MIGHT EXPECT FROM THE HOUSE CHANGES . . . .

CONVENTIONAL RESIDENTIAL HOUSING

(SALE IN YEAR 12)

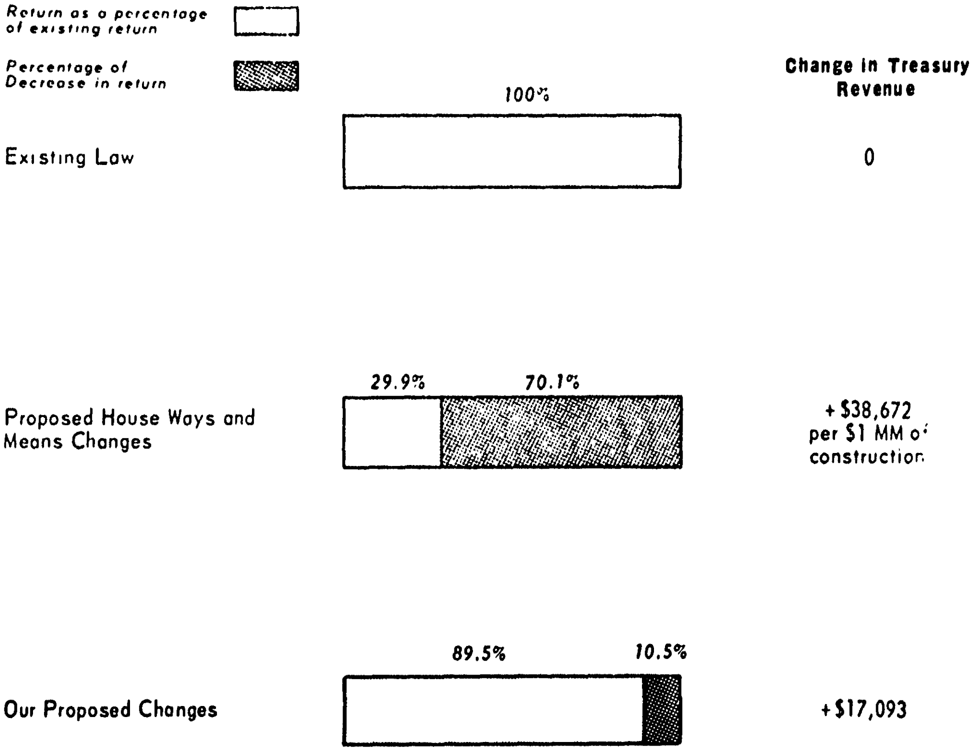


EXHIBIT 10

WE PROPOSE (1) ONLY 25 PERCENT OF THE EXCESS OF ACCELERATED OVER STRAIGHT-LINE DEPRECIATION BE SUBJECT TO LTP AND AOD, AND (2) ALL DEPRECIATION BE SUBJECT TO RECAPTURE WITH SLIDING SCALE STARTING IN 36TH MONTH . . . .

COMMERCIAL AND OFFICE BUILDING CONSTRUCTION
(SALE IN YEAR 5)

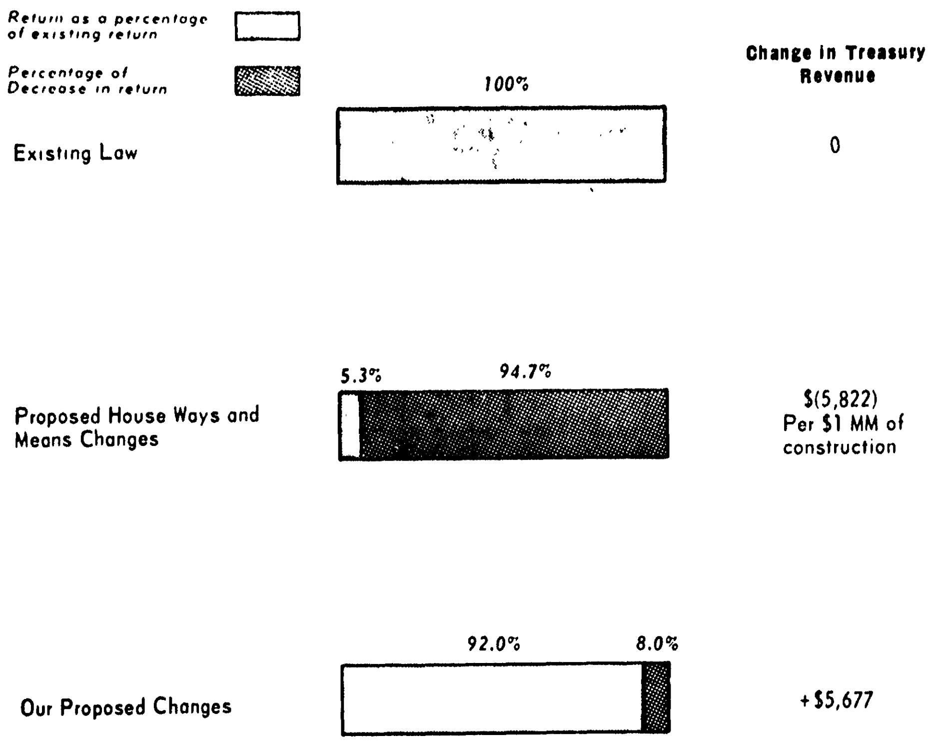
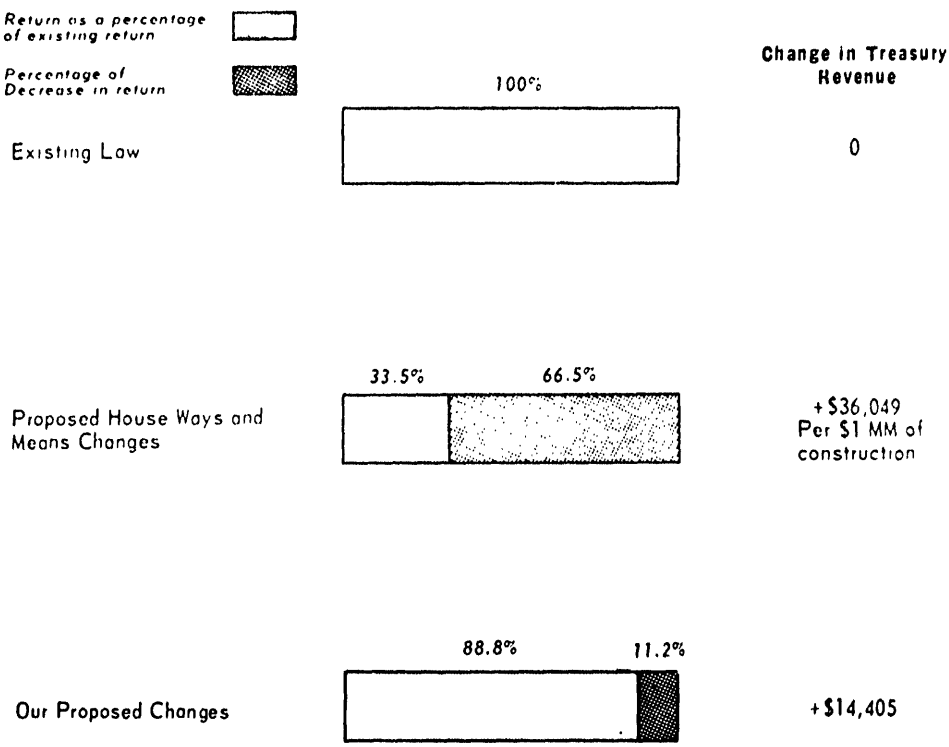


EXHIBIT 11

WE PROPOSE (1) ONLY 25 PERCENT OF THE EXCESS OF ACCELERATED OVER STRAIGHT-LINE DEPRECIATION BE SUBJECT TO LTP AND AOD, AND (2) ALL DEPRECIATION BE SUBJECT TO RECAPURE WITH SLIDING SCALE STARTING IN 36TH MONTH; OUT PROPOSALS GIVE THE TREASURY APPROXIMATELY 40 PERCENT OF THE REVENUE IT MIGHT EXPECT FROM THE HOUSE CHANGES . . . .

COMMERCIAL AND OFFICE BUILDING CONSTRUCTION

(SALE IN YEAR 12)



CAPITAL CONCEPTS CORP.,
Los Angeles, Calif., September 15, 1969.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: It is my considered opinion that it would be a mistake to eliminate accelerated depreciation as proposed in the Tax Reform Bill as reported out of the House of Representatives.

As you are well aware, the present real estate market is in a state of extreme depression. It is very difficult to purchase investment quality real estate and even more difficult to sell investment real estate at a price sufficient to yield a reasonable return on the initial investment. The price of real estate is a function of the economic return that it generates. A substantial portion of the return generated by real estate through the present time has been the tax benefits created by the interest and depreciation deduction allowed to the owner of the real estate.

Our firm specializes in purchasing, for our clients, investment quality real estate. By the end of 1969 our real estate holdings will exceed fifty million dollars. In many cases we will purchase apartment houses where the cash return is quite low but where the tax benefits to the investor are substantial and the potential for appreciation, we feel, is great.

If there were no substantial tax benefits to be gained by owning real estate we would have three courses of action open to us.

1. Pay considerably less money for the real estate, which would result in a higher cash yield to the investor.
2. Pay the same price for the real estate but raise the rents substantially after the purchase.
3. Find another suitable investment vehicle other than real estate.

It is my opinion that the effect of the reduced tax savings will be a substantial across the board increase in rents to raise the return to real estate investors so that the need for residential units can be met. The argument is made that accelerated deprication is continued to be allowed to original owners of apartment houses. That in itself is not satisfactory because firms such as ours only buy existing structures. The initial builders must be able to anticipate a profit on sale or they will not build the building even though the builder may receive the tax benefits.

There are two reasons for this.

1. As you know the tax benefits to the original builder, under the new law, will be illusory because of the recapture provisions.
2. There will be no market to re-sell the property because the second buyers will not receive any tax benefits.

It is my opinion that the economy is a self adjusting device that adjusts for tax benefits. In other words, an investor expects a 15% yield on his invested dollars. He is willing to take part of this yield in tax benefits if they are available. If they are not available then he must have a greater cash yield to offset the lost tax benefits. The net result of this is that if you remove the tax benefits from real estate the yield on real estate will have to rise which will cause increased rents and greater inflation.

Very truly yours,

LAWRENCE M. SCHULNER, *President.*

ARTHUR ANDERSEN & CO.,
Chicago, Ill., September 19, 1969.

Re statement regarding H.R. 13270 Tax Reform Act of 1969—Real Estate Depreciation.

Mr. TOM VAIL,
Chief Counsel, Committee on Finance,
New Senate Office Building, Washington, D.C.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

DEAR MR. VAIL: Recapture of depreciation at ordinary income tax rates should not apply to depreciation on real property on which construction was begun before July 24, 1969, or where a binding contract to construct or acquire had been entered into before July 24, 1969. Drastic changes in the tax consequences of gain on real property which is already subject to inflexible financial arrangements can create real economic loss upon their disposition.

BASIS FOR COMMENTS

Purchasers of real property generally make their investment decisions based on a required rate of return and cash flow, including net after-tax proceeds on the property's disposition at a later date. To date, all such decisions have been made based on long-term capital gain treatment for any gain on disposition, and justifiably so, since all prior tax law has provided for such treatment. Long-term financing with a fixed interest rate has been arranged; correspondingly, long-term leases have been contracted which cannot be revoked. In many cases, purchase options have been granted for dates far in the future, at a price which was determined as resonable *based on capital gain treatment of the gain on disposition.* To change the anticipated tax treatment when all other arrangements have been closed and must remain inflexible will create numerous situations where a previously planned and proven rate of return on an investment will be reduced, at a minimum, to a much lower rate. In many instances, there will be a definite economic loss. In nearly all cases, the resultant rate of return would have been unacceptable if known at the outset.

We realize that Section 1245 was similarly enacted in 1962; however, most tangible property within the scope of 1245 is not purchased primarily as a financial investment, but as a necessary tool in the overall business. Contemplated appreciation and the resultant tax on it are not prime considerations in most purchases of machinery and equipment; hence the enactment of Section 1245 did not create similar problems in 1962. Introduction of Section 1250 in 1964 was not necessarily disastrous, either, since it provided for continued capital gain treatment on long-term holdings. The proposed amendments to Section 1250 and its concomitant financial effects are without parallel in previous tax legislation, and come at a time when inflation has become a major factor in creating taxable gain where economic gain does not exist. Ultimate gain on disposition will, at least in part, not so much be attributable to excess depreciation as it will be to a rising price level and thus result in taxing fictitious rather than real income.

The provisions for amendment of Section 1250 should be revised to provide for recapture of depreciation on future construction or commitments only, to allow investors and businessmen to plan for the tax effect, assuming any extension of Section 1250 is to be enacted.

CONCLUSION

This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and recommendations contained herein be made part of the record of testimony relative to the legislative changes contemplated for real estate depreciation. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

ARTHUR ANDERSEN & CO.,
By JOHN MENDENHALL,
Director of Taxes.

AMERICAN LAND TITLE ASSOCIATION,
Bryn Mawr, Pa., October 1, 1969.

Re Tax Reform Act of 1969.

Senator RUSSELL B. LONG, *Chairman,*
Senate Committee on Finance, New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The American Land Title Association, representing a substantial majority of the more than 2,000 land title evidencing and insuring companies in business throughout the nation, respectfully presents the Senate Finance Committee with its views on certain parts of the Tax Reform Act of 1969.

Evidencing and insuring land titles has afforded members of this Association with an understanding of the real estate business, and we offer our conclusions in the belief that they can be of assistance to the Committee in its consideration of the previously-mentioned Act.

It is the view of this Association that certain parts of the Act threaten to be dangerously inflationary and may well aggravate the already grievous national shortage of housing. Other parts of the Act may produce adverse effects on individual citizens—and on the nation's economy—through alterations in capital gains taxation.

Provisions of the Act that would limit the maximum rate of depreciation on existing property to straight-line depreciation, and that would recapture as ordinary income all depreciation taken in excess of the straight-line method, are, in our view, highly questionable. This effort to restructure the taxes paid by real estate interests could readily bring severe consequences to Americans with low and moderate incomes.

Our main concerns are embodied in the following points:

The Act as proposed would curtail building construction, which would lessen available rental space and force accelerated increases in rental rates, adding to the problems of this nation's already seriously-inflated economy.

The Act as proposed would reduce the economic incentive to construct housing for low and moderate income families; as a result, significant reductions can be anticipated in housing construction under provisions of the Housing Act of 1968, along with further inhibition of attainment of Housing Act goals.

The Act as proposed would tend to realign the financial structure of real estate interests, shifting more of the burden for producing profit to the raising of rentals—including residential rentals.

The Act as proposed would tend to influence real estate interests to invest a smaller share of capital in building single family homes.

In addition, as previously mentioned, we are deeply concerned about the possible impact on investors, employees, and the economy of the nation in general, that may result from changes in capital gains taxation.

In our opinion, provisions of the Tax Reform Act relating to the treatment of and tax rates on capital gains will have a seriously adverse effect on many facets of the national economy. The consequences of increasing the tax rate on capital gains and extending the holding period required to obtain capital gains treatment may critically impair the flow of needed investment capital.

The effect of proposed changes in the treatment of employee contributions to pension plans threatens the economic well-being of employees who have spent a lifetime providing some measure of security for their retirement. It would be most regrettable to see this security diminish as a result of arbitary and inequitable changes in tax legislation.

The net result of the proposed changes cannot help but result in added financial burdens on investors, employers, and employees alike. Ultimately, such burden will reflect itself in higher costs to those individual taxpayers whom the proposed Tax Reform Act purports to benefit.

Following are specific points that are of grave concern to the members of this Association:

The Act as proposed would significantly decrease the performance potential of publicly-held member companies of this Association, as a result of increased taxation on investments in securities—particularly bonds—which are required to meet various state regulations, as well as to fund required reserve. The ultimate effect would be to reduce the flow of new investment in the insurance industry because of unattractive earnings or to cause inflationary pressure on the overall cost of insurance.

The Act as proposed would considerably increase the pension cost for all employers if they are to offset the adverse effects on retirement income resulting from a proposed change in treatment of employee contributions. These additional costs would either adversely affect already shrinking profit margins, or result in inflationary price increases.

The Act as proposed, by increasing the required holding period of investments, would remove a considerable incentive for the small investor who, in many cases, could not afford to have his limited capital tied up for the period required to take advantage of capital gains treatment. Thus, instead of benefiting small individual tax payers for whom the tax reform is intended to provide relief, the proposed change would place an additional tax burden on their income, while at the same time restricting an important source of needed investment capital.

The Act as proposed would discriminate specifically against retiring employees by proposing to tax lump-sum distributions of employee contributions to pension plans as ordinary income. Considering our present system of steeply progressive tax rates, the retiring employee would face the prospect of paying a considerably higher tax on what was intended to be his retirement income—a tax higher than he would have paid had he not tried to provide for his retirement. This type of reform appears to be contrary to public policy and stated government objectives. It defeats the purpose of the plans as originally encouraged by the government and places an additional burden on the social security system, if economic welfare of the retiree is to be maintained above the mere subsistence level.

It is our conclusion that the proposed changes in the Tax Reform Act relating to capital gains taxation will result in regression rather than reform and will thus defeat the original intent of the Congress. We believe that the specific proposals relating to capital gains, if enacted, will contribute to further inflation by removing significant vestiges of incentive for long-term investment on the part of those Americans who should be most encouraged to invest in the future of this nation. Furthermore, the proposed legislation would bring severe additional economic hardship for those who can least afford to bear such a burden. The Tax Reform Act is obviously not intended to produce such adverse results.

In summation, we believe that the Act's "recapture" provision, denial of accelerated depreciation, and provisions related to capital gains taxation—no matter how well-intentioned—would culminate in contributing to greater inflation and placing additional economic hardship on Americans who can least afford it. We respectfully urge that these portions of the Act not be permitted to become law.

Sincerely,

GORDON M. BURLINGAME,
President, American Land Title Association.

STATEMENT BY EDWIN M. HOOD, PRESIDENT, SHIPBUILDERS COUNCIL OF AMERICA, WASHINGTON, D.C.

I. PROPOSED AMENDMENTS TO THE TAX REFORM BILL OF 1969

The Shipbuilders Council of America, composed of major shipbuilding companies and allied suppliers in all sections of the United States, proposes amendments to HR-13270 (the Tax Reform Act of 1969) to accomplish the following:

(1) A 15 percent write-off between contract and delivery dates of new vessels.

(2) A ten-year ship life for tax purposes.

(3) A special additional depreciation allowance of 30 percent for the first five years after delivery of a new ship.

(4) Tax exemption of the proceeds of ship sales reinvested in new ships.

(5) A tax deduction for lenders of a percentage of interest, leasing and charter income from new ships.

For an evaluation of the merit of these techniques, there is attached as Appendix A a paper entitled "Investment Incentives for the Maritime Industry" prepared by Dr. Jacob J. Kaplan of Washington, D.C., an independent consultant on international finance and economics.

II. WHY THE PROPOSED AMENDMENTS ARE NECESSARY

All of the reasons compelling adoption of the above proposed amendments to HR-13270 are variations of one central theme—the present United States Merchant Marine desperately needs incentives for investment in new United States flag vessels. Because of inadequate financing, levels of ship construction in the past decade have failed to offset the impediments of age and inefficiency which have plagued the nation's shipping fleet.

The United States Merchant Marine is largely comprised of vessels that are obsolete—85 percent of the combined government-owned and privately-owned fleet today registered under the American-flag is 20 years of age and older. What newer investment there has been, over the past decade, relates primarily to vessels built through governmental subsidies, representing substantial cost to the government but applying to less than one-third the present fleet.

These statistics simply confirm that if maintenance of the United States Merchant Marine is of national importance—and there is virtually no debate on this point—private investment has not been sufficiently attracted. Some alternative approach—to stimulate private investment—is obviously in order, and the proposed amendments are designed to provide that stimulus.

The obsolescence and decline of the American Merchant Marine is further illustrated by the fact that only 6.5 percent of United States oceanborne foreign trade was carried on U.S. flag vessels in 1967. When this figure is compared with the goal of The Merchant Marine Act of 1936 that the United States fleet carry 30% of the nation's foreign trade and with the 1950 performance in which 39 percent of the nation's foreign trade tonnage was transported on United States bottoms, the need for providing incentives for private investment in domestic built vessels becomes dramatically apparent.

From its position as the world's greatest shipbuilding nation at the end of World War II, the United States has slipped to 12th place in terms of annual commercial tonnage constructed. The American-flag merchant fleet, which at the end of World War II was the largest in the world, now ranks fifth and will plummet further in global standing in the years ahead unless corrective incentives are instituted promptly.

Since 1946, American owners or their affiliated corporations have purchased approximately 1,650 new foreign built merchant vessels of nearly 35,700,000 dwt. to be sailed under "flags of convenience" or other foreign registry. During the same period, only 484 commercial vessels of approximately 7,800,000 dwt. have been built in United States shipyards to be sailed under the United States flag.

In these times of sharply increasing international trade and tensions, the United States has become dangerously dependent upon foreign-flag vessels built in foreign yards and manned with foreign crews for import and export, as well as for defense purposes. An additional consequence of this situation is the adverse effect upon the nation's balance of payments deficit. The combination of United States companies' purchases of foreign built vessels (estimated to have totalled between $5 billion and $8 billion since 1946), wage payments to foreign crews plus United States manufacturers' and retailers' shipping payments to foreign shippers add up to a very heavy drain on the United States balance of payments.

The decrease in the United States Merchant Marine is of extreme national importance. President Nixon has stated the need for "the restoration of the United States as a first-rate maritime power." In view of the essentiality of a sound U.S. shipping fleet, and in view of the drastic need for its improvement, the construction of ships in U.S. shipyards for commercial operation under the United States-flag must be stimulated. This is not the time to remove incentives for private investment in new U.S. vessels, yet HR-13270 in its present form would eliminate the investment tax credit with respect to oceangoing vessels.

III. GENERAL EXPLANATION OF PROPOSALS

The Shipbuilders Council of America submits that, given adequate economic incentives, United States private enterprise can significantly contribute to an improvement in the Merchant Marine situation so as to enable decreasing direct outlays on the part of the Federal Government. The Council believes that tax incentives can help provide a favorable shipbuilding climate at less cost than direct subsidies with their dependence on annual appropriations and limitations to only a part of the American fleet.

Although the investment tax credit has not been sufficient alone to solve the maritime problem, some enterprising United States shipbuilders and operators have used the investment tax credit for construction of vessels that might otherwise have been built overseas. Its loss would further hinder a nation seeking to re-establish itself as a first-rate maritime power within the framework of the free enterprise system.

The Shipbuilders Council of America submits that national interest and national security are vitally affected by the status of the United States Merchant Marine, and hence requires urgent attention, sufficient stimulli and adequate incentives.

IV. TECHNICAL EXPLANATION OF PROPOSALS

As demonstrated in Dr. Kaplan's report, the Shipbuilders Council of America recommends incorporation into HR-13270 of the following alternative tax incentives for investment in a sound United States Merchant Marine:

1. The purchaser of an oceangoing vessel constructed or reconstructed in a United States shipyard shall be entitled to commence depreciating the vessel upon entering a binding shipbuilding contract. The depreciation allowable during the construction period (commencing with execution of the shipbuilding contract and ending with delivery of the vessel) shall be limited to 15 percent of the vessel's contract price. The completed vessel's cost basis for regular depreciation deduction should be available only with respect to vessels which are not the subject of a construction differential subsidy, thus providing an economic incentive for a ship operator to forego obtaining direct governmental subsidy.

2. The owner of an oceangoing vessel which is constructed or reconstructed in a United States shipyard and which is not the subject of a construction differential subsidy shall be permitted to amortize the cost of the vessel over a ten-year period. This provision would be compatible with Section 705 of HR-13270, permitting accelerated amortization of railroad cars, on the basis that the national interest will be served by similar treatment for oceangoing vessels. The exclusion of vessels subject to a construction differential subsidy is, of course, for the purpose of encouraging operators to forego direct governmental subsidy.

3. The owner of an oceangoing vessel constructed or reconstructed in a United States shipyard shall be entitled to an additional depreciation allowance of up to 30 percent of the vessel's cost during the first five years of its operation. Such depreciation shall be in addition to the depreciation otherwise allowable, in the same manner as additional first year depreciation is presently allowed for small business under Section 179 of the Internal Revenue Code. The taxpayer-owner shall be entitled to elect in each of the first five years to take any amount of such additional depreciation, but the amount claimed in any one year shall not exceed 10 percent of the vessel's cost. The additional first year depreciation shall be limited to vessels which are not the subject of a construction differential subsidy, as previously described.

4. Any gain on the sale of an oceangonig vessel shall not be recognized for tax purposes if, within a period beginning one year before the sale and ending one year after the sale, the taxpayer enters a contract to acquire a newly constructed or reconstructed oceangoing vessel. The nonrecognition of gain shall apply much in the manner that Section 1034 of the Internal Revenue Code presently provides for nonrecognition of gain on the sale or exchange of a residence, thus requiring the new vessel's purchase price exceed the old vessel's sales price for complete nonrecognition. The nonrecognition shall, of course, apply to defer recognition of depreciation recapture (under Section 1245 of the Internal Revenue Code) as well as capital gain. As with respect to sale or exchange of a residence under Section 1034, the cost basis of the newly acquired vessel shall be reduced by the amount of gain deferred. Similarly, the amount of depreciation recapture deferred upon sale of the old vessel shall be carried over until sale of the new vessel (or a succeeding vessel) results in a recognized gain. As in the previously suggested provisions, this nonrecognition of gain shall apply if the newly constructed vessel is not the subject of a construction differential subsidy.

5. Financial institutions shall be entitled to except from their interest income an amount equal to 10 percent of the interest received under construction and mortgage loans with respect to oceangoing vessels constructed or reconstructed in a United States shipyard. Similarly, recognizing that financing institutions and others will in some cases actually take ownership of vessels and charter them to operators in order to finance the operators' use of the vessels, such institutions and others shall be entitled to exempt from gross income an equivalent portion of the charter hire as it is received. The exemption of both interest and charter income shall, as previously described, apply only with respect to vessels which are not the subject of a construction differential subsidy. This provision would conform to the deduction for interest upon residential real property loans, student loans and other loans in the national interest, as recommended by Assistant Secretary of the Treasury Cohen before the Senate Finance Committee on September 4, 1969.

Appendix A—Investment Incentives for the Maritime Industry

(Prepared for Shipbuilders Council of America, Washington, D.C., September 1969 by Jacob J. Kaplan, consultant, Washington, D.C.)

SUMMARY

The obsolescence of the U.S. merchant marine has proceeded to the point where major decisions can no longer be deferred by the U.S. government. For at least a decade, other pressing concerns have been given priority while policy makers took some comfort from the continued existence of a large fleet of ships built during World War II. With the passage of a quarter of a century since they were built, such vessels cannot be counted upon any longer for reliable carriage of goods in international trade. They have, of course, long passed the point of competitiveness. Other countries have taken advantage of advances in marine technology and ship size to increase and modernize their fleets with newer and much more efficient vessels.

U.S. flag ships carried 6.5 percent of U.S. oceanborne foreign trade in 1967, a steady and persistent decline from the 39 percent level of 1950. The number of new merchant vessels completed in U.S. yards averaged 15 per year over the last five calendar years. Even these low levels of U.S. shipbuilding and U.S. participation in the carriage of its overseas trade required substantial U.S. government budgetary expenditures. Such charges on the federal budget stem from higher wages and other costs prevailing in the United States. However, they also result from the operation of economically obsolete vessels and the low volume of merchant ship construction in U.S. yards.

The present inadequacy of the U.S. merchant marine—and the prospect of continued deterioration—involves increased national security risks and reduced options for the U.S. government in dealing with emergency situations that may arise. In recent years, the Soviet Union has placed a very high priority on the expansion and modernization of its merchant fleet.

A significant contribution to correction of the U.S. balance of payments problem would be made if the U.S. merchant marine was expanded and if owners turned to U.S. shipyards rather than buying vessels abroad for operation under U.S. and foreign flags. The purchase of ships by U.S. nationals from foreign yards involves large and increasing sums of foreign exchange. Without appropriate incentives for investment in U.S. built ships, the U.S. balance of payments will suffer significant further damage.

Investment incentive techniques have been very effective in other industrialized countries that boast of much younger and more competitive merchant marines. The following techniques should be considered for application in the U.S.:

(1) A 15 percent write-off between the contract and delivery dates of new vessels.

(2) A ten-year ship life for tax purposes.

(3) A special additional depreciation allowance of 30 percent for the first five years after delivery of a new ship.

(4) Tax exemption of the proceeds of ship sales reinvested in new ships.

(5) A tax deduction for lenders of a percentage of interest, leasing and charter income from new ships.

BLOCK OBSOLESCENCE OF THE U.S. MERCHANT MARINE CAN NO LONGER BE IGNORED

The Merchant Marine Act of 1936 confirmed the statutory life of vessels at 20 years, a reasonable estimate of the economic life of oceangoing ships under then prevailing conditions. Amendments to the Act in 1960 extended that life to 25 years for vessels other than tankers and other liquid bulk carriers. The amendments reflected physical longevity rather than the rate of economic obsolescence. Internal Revenue Service guidelines on depreciation for tax purposes suggest 18 years for ships.

Actually, the rate of technological advance in shipping has been much accelerated during the 1960's. Larger and faster ships with more sophisticated equipment offer important economies so that the more competitive fleets have been rapidly replacing older tonnage. With wage rates rising rapidly in all industrialized countries, the incentive to take advantage of further advances in ship technology remains high. For such countries, the economic life of vessels that must operate under international competitive conditions is unlikely to exceed ten years and may well be much less.

The U.S. Fleet is strinkingly overage

On September 30, 1946, the U.S. merchant marine consisted of 4,852 vessels,[1] most of them built during World War II for government account. Only 2,332 of these ships were then active in foreign and domestic trade. The very size of the inactive fleet minimized the national security requirements for building additional ships in the post-war years, whatever the economies offered by newer vessels.

By the end of 1966, however, the U.S. merchant marine had fallen to 2,278 vessels. Of this total, 1,313 were government-owned, with an average age of 23 years.[2]

By mid-1959, the last of the inactiveships that were desirable for reconversion had been sold to private operators. On July 1, 1969, only 1,050 ships[3] remained under government ownership, a third of them classified by the Maritime Administration as "scrap." Only 72 out of 172 ships activated to meet Vietnam requirements remained in full operating status. In another five years, the reserve fleet will have few, if any, World War II vintage vessels that can be depended upon.

As for the privately-owned U.S. flag fleet, it numbered 965 ships at the end of 1966, with an average age of 19 years. Despite sales from the government-owned fleet and some new construction, the privately-owned fleet numbered 963 ships on July 1, 1969.

The dry bulk carrier segment of the fleet is in particularly bad shape. Not only had the number of such ships declined to 53 by mid-1968,[5] but their average age at that time was 24 years. Time has run out, even on the statutory life decreed for subsidized ships by the 1960 amendments.

The privately-owned freighter and tanker fleets are not much younger. Two-and-a-half years ago, their average age was 19 years and 17 years respectively.

The older ships are inefficient and cannot compete with newer vessels

They are generally smaller and slower than ships built in recent years. They suffer more breakdowns and need more repairs. Insurers are seeking higher premiums for aged vessels. Rising living standards and wages put a premium on the efficient use of labor. Ships now being ordered on the world market carry several times the cargo of vessels built in the 1940's, frequently at manning levels below that of older ships. Four tankers are now being built for the U.S. flag fleet with a deadweight tonnage of 35,000 and a manning level of 23 that seems to be acceptable to the unions. The much smaller tankers built ten or 20 years ago have crews twice as large. Orders for 120,000-ton tankers have recently been placed in U.S. yards. While no manning level has been announced for these ships, it could well approximate that for the 35,000-ton vessels.

U.S. wage levels present a formidable obstacle to the operation of ships with U.S. crews in competition with those manned by nationals of lower wage countries. Nevertheless, the container ship experience demonstrates that U.S. operators who are able to move to the forefront in applying modern ship technology may be able to face such competition successfully and profitably, at least for part of the traffic.

The situation of the dry bulk cargo operators demonstrates the results of trying to operate highly obsolete vessels under the U.S. flag. Their ships are able to compete only for U.S. government sponsored cargoes that must be carried on U.S. flag ships. Last year charter rates for such vessels to carry grain from the U.S. Gulf to India ran as much as $29 per ton. For the same cargo and voyage, rates of $12 a ton were fixed for internationally competitive cargoes. A recent study estimated that a new 40,000 ton vessel built in U.S. yards without subsidy and using U.S. crews could carry such cargo profitably at $16 per ton.[6]

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[1] Maritime Administration, *Employment Report*, June 1968.

[2] Maritime Administration, *A Statistical Analysis of the World's Merchant Fleets*, December 1966.

[3] Maritime Administration, *Merchant Marine Data Sheet*, July 1, 1969.

[5] Fernley and Eggers Chartering Co., Ltd., quoted by Booz Allen Applied Research, Inc., *The National Need for a Dry Bulk Fleet*, February 1969.

[6] Booz Allen and Hamilton, Inc., *Alternative Financing Methods for a Dry Bulk Ship Program*, May 1969, p. 20.

Competitor Fleets are Much Younger on the Average

The U.S. merchant fleet is about twice as old, on the average, as the fleets of other industrialized countries. The data in Table No. 1 reflect the situation as of the end of 1966, the latest date for which complete data are readily available. In the interim, the other countries listed have received delivery on a large number of new vessels, so that the disparity between the average age of their fleets and ours has increased. The order books suggest that the disparity will continue to increase over the next few years, no matter how promptly the U.S. begins the renovation of its merchant marine.

TABLE NO. I.—MERCHANT FLEETS OF INDUSTRIALIZED COUNTRIES, NUMBER AND AGE, END OF 1966

Country	Total		Freighters		Bulk carriers		Tankers	
	Number	Average age (years)	Number	age (years)	Number	age (years)	Number	age (years)
U.S., privately owned	965	19	606	19	57	22	275	17
Denmark	342	10	246	10	19	8	57	6
Germany, Federal Republic	860	11	725	11	69	9	51	10
Japan	1,406	9	881	10	234	6	265	7
Netherlands	469	11	311	11	34	7	88	10
Norway	1,356	10	616	12	256	6	455	8
Sweden	433	11	265	13	85	9	74	7
United Kingdom	1,985	12	1,154	12	297	10	423	10

Source: Maritime Administration, A Statistical Analysis of the World's Merchant Fleets, December 1966, p. 1.

The differences in average age reflect disparities in average size, speed and other efficiency factors. The United States fleet will not begin to move toward greater competitiveness with the merchant marine of these countries until it too initiates a substantial program for the replacement of overage tonnage.

The Youthfulness of Foreign Fleets Reflects the Effectiveness of Regulations that Encourage Fast Depreciation and Reinvestment of the Proceeds of Ship Sales

The countries with much more youthful merchant marines than the U.S. all encourage much faster depreciation of new ships.[7] Earnings before depreciation on a new ship tend to be high because its new features attract cargoes. Moreover, maintenance and repair costs are at a minimum, as is time lost for repair and maintenance. Higher depreciation allowances in these early years permit a higher cash flow to the operators at the expense of taxable earnings. If the operator can sell his ship after accelerated depreciation allowances have been used up, and either defer tax payments on his net profit over book value or pay such taxes at reduced rates, he has a substantial incentive to buy a new ship. These incentives exist in every country listed in Table No. I, except the United States.

Thus since April 1965, the owner of a U. K. ship may claim depreciation at any rate he chooses for each year. In effect, he can take the entire depreciation for one ship in one year if feasible and his profits permit. The U. K. does not tax capital gains.

Sweden permits depreciation of 30 percent of book value per year or a complete write-off in five years. Thirty percent of the contracted price may be depreciated prior to delivery of the vessel. Taxable earnings from the sale of vessels may be transferred to a special fund which, if used to acquire new vessels, is not taxable.

Germany permits depreciation of a dry cargo ship over 15 years and a tanker over 12 years, using either a straight line or a declining percentage that may not exceed twice the applicable straight line percentage. However, between 1965 and 1970, a special depreciation of up to 30 percent may be taken during the first five consecutive years. Book profits from the sale of a ship may be transferred without tax to a replacement ship.

Norway permits accelerated depreciation up to 25 percent of cost, beginning as soon as the first installment has been paid under a new building contract. If used

[7] See Maritime Administration, *Maritime Subsidies*, 1969. Details on depreciation allowances and tax treatment of ship operators are provided for most maritime countries.

on a ship for which ordinary depreciation is seven percent, the vessel will be written-off within 11 years. Capital gains may be put in a special fund and used to finance new investments.

By contrast to such treatment, U.S. operators are expected to depreciate an unsubsidized vessel over an 18 year period. Subsidized vessels are depreciated over 20 or 25 years. The declining balance and sum-of-the-year digits methods of accelerated depreciation may be adopted. Income tax at regular rates, rather than at capital gain rates, must be paid on the proceeds of the sale of a ship. The subsidized operator only gains tax advantages from the possibility of depositing earnings in a capital reserve fund for the purchase of new ships. On the other hand, such a fund establishes no special incentive for early investment in new ships. Unlike the operators of foreign flag ships, the U.S. operator has substantial underpreciated value for tax purposes on his ten-year old ship and less incentive to contemplate replacement.

U.S. Flag Ships Now Carry Only a Token Percentage of U.S. Foreign Trade

In 1967, U.S. flag ships carried fewer than 29 million tons of U.S. imports and exports, less than half as much as in 1950. This absolute decline reflects a much more dramatic drop in the percentage of total U.S. waterborne trade carried in U.S. bottoms. Though U.S. waterborne imports and exports tripled in tonnage over this period, the decline in the share of the U.S. flag fleet has been continuous and persistent since 1950. That share equalled 39 percent in 1950, 23.5 percent in 1955, 12.3 in 1960, 8.1 in 1965, and only 6.5 in 1967.

TABLE II.—U.S. WATERBORNE IMPORTS AND EXPORTS, 1950–67

Year	Tonnage (millions of short tons)			U.S.-flag ships (in percent)		
	Total	Dry cargo	Tanker cargo	Total	Dry cargo	Tanker cargo
1950	159	100	59	39.3	31.2	53.0
1955	254	169	85	23.5	23.2	23.5
1960	323	202	120	12.3	15.2	7.5
1965	427	274	153	8.1	9.3	5.9
1967	444	294	150	6.5	8.1	3.4

Source: Bureau of Census, Statistical Abstract of the United States, 1969.

The Level of Output of the U.S. Merchant Shipbuilding Industry Has Been Much Too Low To Permit Production at Minimum Cost

Over the past five years, 1963–1968, an average of only 15 merchant ships a year were completed in all U.S. shipyards. The level of output has been dependent primarily on the availability of government construction subsidies.

A variety of expert opinion has emphasized the economies inherent in producing a standardized ship in series. For example, the Booz Allen study previously mentioned estimated the cost of its 40,000 ton dry bulk ship at $16 million for the first ship, but $12.1 per ship if an order of 15 ships were placed with a single U.S. yard. Because U.S. labor skills and wage rates are both high, the economies of serial production are undoubtedly much greater than in foreign yards. Given a substantially higher volume of orders and some reasonable assurance that the higher level would be maintained for a period of years, the U.S. shipbuilding industry is likely to become more specialized and adapted to serial production.

The industry has no significant recent experience with the economies of serial production, so that estimates of possible cost reduction per ship may well be conservative. The full economies can only be known after several U.S. yards experience orders for a standardized vessel in series of fifteen each, repeated for the same or another standardized ship well before production of the first series is completed. With such a pattern of orders on their books, U.S. yards would be able to equip themselves appropriately, order more efficiently from suppliers and organize their production so as to take full advantage of modern shipbuilding technology and the skills of U.S. labor and management.

Since the investment tax credit was enacted in 1962, U.S. shipyards have engaged in a substantial investment program designed to expand and modernize their capacity. According to the Census Bureau,[8] new capital expenditures by the industry have risen steadily—from $23 million in 1962 to $24.5 million in 1963, $32.8 million in 1964, $44.2 million in 1965, $52.8 million in 1966 and $66 million in 1967. Reports to the Shipbuilders Council indicate that the figure of 1968 approximated $100 million. If substantial replacement of obsolete ships in the U.S. fleet is to be achieved, this investment program in U.S. shipyards must be continued.

This ambitious and costly program was stimulated by the availability of investment tax credits to ship operators and by an expectation that the government of the United States would soon take substantial measures to overcome the block obsolescence of the U.S. merchant fleet.

In the last two years, orders for new U.S. built ships have increased, primarily for new tanker tonnage. Without tax incentives or other government support, even this modest step toward renovation of the U.S. merchant marine may be set back.

The Maintenance of Inefficient Ships in the U.S. Fleet Involves Substantial Costs to the Federal Budget

Ship operating subsidies for liners engaged in serving Essential Trade Routes at international cargo rates have been running at about $200 million per year. Otherwise, overage vessels have been able to continue in service only in protected markets—domestic shipping and government-sponsored cargoes in foreign trade. Rates have been substantially higher than would be required on efficient new ships. The use of such ships increased the costs and expenditures of the Departments of Defense and Agriculture as well as the Agency for International Development. A modern dry bulk cargo fleet might save 75 percent of the transportation costs now borne by the Department of Agriculture's Food for Peace program. These costs have amounted to as much as $80 million a year.

THE NATIONAL INTEREST IN THE MERCHANT MARINE

It is unprecedented for a major power to become as dependent on foreign flag fleets for the transport of its international commerce as has the United States. It is possible to take comfort from the fact that adequate shipping has been available even during periods of international crisis. However, with the prospective disappearance of the reserve fleet, U.S. flexibility and credibility during future crisis situations may be seriously restricted.

The Soviet Union has come to place a much higher priority on the development of its own merchant marine. It has grown from 1.8 million deadweight tons in 1950 to 3.6 million in 1958 and about 12 million tons at present. In November of 1968, it was reported to have 458 ships on order, aggregating more than four million deadweight tons. At the same time, only 62 ships were on order for the U.S. fleet, totalling 1.8 million deadweight tons.

However one views the security implications of U.S. dependence on foreign flag shipping, the foreign exchange costs are high. The U.S. balance of payments deficit has averaged about $2 billion per year throughout the 1960's and gives little evidence of improvement. The U.S. surplus on merchandise trade virtually disappeared in 1968. The Department of Commerce [9] is pessimistic about the prospect for reestablishing the large trade surpluses which existed even in the mid-1960's.

In such circumstances a significant national interest must prevail in saving foreign exchange or finding new avenues for earning foreign exchange without causing serious disruption in the free flow of international commerce. A recent study concluded that the U. S. balance of payments "would have suffered a loss of approximately $2.2 billion for the three year period 1964–1966 if the shipping services performed by the U. S. flag fleet . . . had been performed instead by foreign owned and operated vessels."[10] Since the U. S. fleet carried less than ten percent of U. S. foreign trade in that period, a modest improvement in its share of U. S. foreign commerce would have made a significant contribution toward ameliorating the U. S. balance of payments deficit.

Perhaps even more serious is the cost of ships purchased from foreign yards by U. S. nationals. Since 1946, 1650 new ships were purchased for registry under

[8] Published in reports of the *Annual Survey of Manufacturers.*
[9] U.S. Department of Commerce, *U.S. Foreign Trade: A Five Year Outlook*, 1969.
[10] Harbridge House, *The Balance of Payments and the U.S. Merchant Marine*, 1968, p. 7.

foreign flags. The U. S. balance of payments accounts keep no separate record of expenditures for such purchases, but they must have totalled $5 billion and may well have reached $8 billion. There is no sign of any diminution in these purchases.

Recently a single U. S. operator ordered eight ships from European yards at a reported cost in excess of $250 million. These vessels are to be financed abroad, so that purchase and interest costs together are likely to aggregate at least $350 million, a foreign exchange cost to the U. S. which could have been avoided if the ships were obtainable from U. S. yards at comparable cost to the operator.

The President has reasserted a goal of carrying 30 percent of U. S. foreign trade on U. S. flag ships. Though the past year has been one of substantial debate and dissent about a wide variety of national goals and priorities, this one has been remarkably free of criticism. In any reasonable assessment of national needs, the maintenance of a substantial merchant marine must claim serious attention. The merchant marine today requires prompt and effective measures to cope with its advanced obsolescence.

Using Investment Incentives To Modernize the U.S. Merchant Marine

In a free enterprise system, investment incentives through the tax system can be a potent force for achieving national purposes. If the objective be to expand and modernize the privately operated U.S. fleet with ships built in private U.S. shipyards, it is likely to be realized sooner and more efficiently through such incentives.

The investment tax credit was a most potent instrument for raising business investment and accelerating plant expansion and modernization in the U.S. economy as a whole. Indeed the proposal to eliminate it stems from the belief that such investment proceeded so rapidly that its pace can now be moderated. Resources need to be directed more toward other national priorities such as urban problems and poverty. If the maritime industry also deserves priority attention, it should seek investment incentives through the tax system to encourage rapid modernization of the merchant marine.

Investment Incentives Are an Efficient Way To Promote Expansion and Modernization of the Merchant Marine

The problems of the U.S. merchant marine are attributable, in some degree, to the direct subsidy techniques through which it has received government support. The administrators of public funds are accountable for their expenditure. They must therefore supervise the use of public funds in great detail and review decisions with great caution. A competitive private enterprise, however, requires flexibility and decisiveness. Success usually comes to those who are prepared to innovate and take risks on the basis of experienced judgment. The administration of maritime subsidies brings these legitimate concerns of officials and business men into constant conflict. The efficiency of the U.S. maritime industry has undoubtedly been victimized by such conflicts. Moreover, the system depends on annual decisions by the Executive Branch and the Congress concerning how much money is to be available. Uncertainty, instability, indecisiveness and overcautious supervision are thus loaded on the industry by the subsidy system.

Investment incentives through tax legislation have important advantages over the present methods used by the government to support the merchant marine. Shipbuilders and operators can count on their availability, unless another legislative process modifies them. The incentives for shipbuilders to reduce construction costs and for operators to maximize revenues and to minimize operating costs will be greater. The benefits of efficiency will accrue to the builders and operators and will show up in their earnings reports. The government will share in these benefits through income tax collections.

A Variety of Techniques Should be Employed to Provide Effective Investment Incentives to the Maritime Industry

Permitting operators to depreciate new ships rapidly for tax purposes is probably the most efficient technique, particularly if the proceeds from the sale of a heavily depreciated vessel can be fully reinvested in new ships free of tax payments.

A two year period normally elapses between the signing of a contract for a new ship and the delivery of the completed vessel. Down payments must be made and a construction loan obtained and serviced long before the operator realizes income from operating the vessel. At current interest levels, such costs are a significant burden, particularly for small operators. If the operator were permitted to charge depreciation on the vessel under construction against the earnings of ships already in operation, he can realize part of the down payment he must make on the new ship.

While U.S. tax law permits the use of any reasonable depreciation method consistently applied, Internal Revenue Service guidelines certainly inhibit departures from the 18 years suggested therein. Even if the accelerated depreciation techniques generally available to U.S. taxpayers are adopted by the ship operators, the result is aan unrealistically low rate of write-off of ship costs. Relatively high earnings during the first years after a new ship is delivered produce large tax liabilities and a modest cash flow to the operator. In later years, the relatively large undepreciated balance encourages continued operation of older vessels, despite lower earning power and higher operating costs.

A powerful incentive for modernization would be established—and the financing problems of small operators would be eased considerably—if owners were permitted to write-off the full cost of a new ship within ten years, using accelerated depreciation methods as earnings permit. To facilitate financing downpayments, they should be permitted to write-off at least 15 percent of the cost of a new ship between the contract and delivery dates.

To initiate rapidly, a substantial modernization program for the U.S. merchant marine, a special depreciation allowance might be offered on new ships for which contracts are placed before 1975. Owners would be permitted to depreciate 30 percent of the contractual cost within the first five years after delivery of the vessel, in addition to regular depreciation charges for those years. Such an allowance would offer owners a significant inducement to contract for replacement tonnage within the next five years. Owners taking advantage of such a provision would be able to increase their depreciation charges in any of the first five operating years of a new vessel in which earnings prove to be high, thus augmenting their cash flow at the expense of their tax liability.

While U.S. flag ships should not be expected to have an economic life in excess of ten years, the ships would continue to be attractive to the fleets of lower wage countries. A substantial international market should continue to exist for such vessels and U.S. owners should expect to sell new ships within a ten-year period for sums considerably in excess of scrap value. If the proceeds of such sales were exempt from taxation provided that they are reinvested in new ships within a few years, operators would be encouraged both to take advantage of the new depreciation allowances and to replace ships as annual depreciation charges diminish.

Such incentives should attract specialized financial institutions to invest in new ships under leasing or long-term charter arrangements, as well as ship operators. New sources of private capital for the maritime industries might then be developed.

Lenders would also be attracted by a special tax deduction on gross interest income from construction and mortgage loans on new ships, as well as on lease or charter income from new ships. Such a deduction should reduce the high interest rates currently required on ship mortgages, as well as draw private capital to financing the fleet modernization program. A similar reduction has been recommended by the Treasury as an incentive for investment in residential real property loans, student loans and "certain other loans which are made pursuant to national policy objectives." [11]

Investment incentives such as the foregoing have played a major role in the modernization of foreign flag fleets. They should also be effective under U.S. conditions. If the incentives are restricted to new ships ordered from U.S. yards, the annual cost to the Treasury in the form of taxes foregone would be nominal for the next few years. As the numbers of ships involved increase, losses of tax receipts would be offset in substantial measure by reductions in budget expenditures for government sponsored cargoes. Moreover, despite such depreciation allowances, a profitable merchant marine and shipbuilding industry will be a better source of tax revenues than the present obsolete fleet and shipyards building a few ships a year. As for the balance of payments of the United States, it would benefit by a multiple of any reduction in tax collections.

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[11] Statement by the Assistant Secretary of the Treasury for Tax Policy before the Senate Finance Committee, September 4, 1969.

APPENDIX B

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF PUBLIC UTILITY DEPRECIATION

Written testimony received by the committee expressing an interest in the subject of public utility depreciation

CIVIL AERONAUTICS BOARD,
Washington, D.C., September 26, 1969.

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

DEAR MR. CHAIRMAN: The Board appreciates this opportunity to comment on H.R. 13270, the "Tax Reform Act of 1969." The Board's central concern is with Subtitle F of the bill. Although that Subtitle contains new rules concerning rapid depreciation for most regulated industries, the legislative language excludes air carriers from the list of affected industries. The Board supports this proposal to exclude air carriers from the scope of Subtitle F.

For most regulated industries, Subtitle F amends IRC section 167 and lays down special rules for depreciation for both "existing" and new public utility property. For new property, the bill in effect precludes regulatory commissions from setting rates under the flow-through method for companies which now use straight-line depreciation for tax purposes, or which use rapid depreciation for tax purposes and normalize for regulatory purposes. The bill achieves this result by denying those companies the right to use rapid depreciation for tax purposes *unless* they also use the normalization method for regulatory purposes. Hence, the only utilities which will be allowed to use rapid depreciation for tax purposes and flow through for regulatory purposes on new property will be utilities which have used flow through for regulatory purposes.

For "existing" property, the bill in effect freezes the status quo. First, utilities which now use straight-line depreciation on existing property for tax purposes cannot shift to rapid depreciation for tax purposes with respect to that property. Second, companies which use rapid depreciation on existing property for tax purposes and flow through the benefits to the consumers may continue to use rapid depreciation for tax purposes and flow through for regulatory purposes. Finally, companies which use rapid depreciation for tax purposes but normalize for regulatory purposes may continue to use rapid depreciation for tax purposes only if they also continue to use normalization for regulatory purposes.

Because H.R. 13270 now excludes air carriers from these new rules, it will not affect the Civil Aeronautics Board's regulatory powers. As you know, the Board differs from most other ratemaking agencies in that its functions include both commercial ratemaking and also subsidy determinations. In commecrial ratemaking, the only Board ruling on rapid depreciation is the *General Passenger Fare Investigation*, 32 C.A.B. 291, 326–327 (1960). On the basis of the record in that proceeding, the Board concluded that the Federal income tax expense which should be recognized for ratemaking purposes is the normal tax that is paid under straight-line depreciation, rather than the actual tax paid under the liberalized provisions of the Internal Revenue Code. The Board favored the normalization method because it believed that "* * * Congress intended that utilities should retain the benefits of section 167" (*Id.* at 327). Although the Board's 1960 reading of legislative intent accorded with the then-prevailing legal interpretations of the rapid depreciation statute, more recent Federal judicial decisions have held that normalization is not necessary to effectuate the Congressional objective expressed in section 167. The Board therefore regards itself as free under present law to reexamine how it should treat rapid depreciation for ratemaking purposes. If H.R. 13270 is expanded to cover air carriers, however, the Board will in effect be prevented from deciding whether liberalized depreciation results in a tax saving and, if so, from treating it accordingly for ratemaking purposes.

As to subsidy determinations, the Board and the courts have interpreted section 406(b) of the Act, which requires that subsidy payments be limited to current "need," as allowing tax benefits from rapid depreciation to be used to reduce the carriers' subsidy. (See *Reopened Pan American Mail-Rate Case*, 35 C.A.B. 540, 555 (1962) *Trans World Airlines* v. *C.A.B.* 385 F. 2d 648 (D.C. Cir. 1967).) If H.R 13270 is expanded to cover air carriers, the Board assumes that the bill's language should be construed as allowing the Board to use the tax benefits to reduce subsidy, as the Board has done in the past. But since the Board's present class rates for subsidized carriers employ the normalization method (rather than the flow-through method), the subsidized carriers might argue that a version of H.R. 13270 which covers air carriers would entitle subsidized carriers to compute their subsidy on a normalization basis. If the Board is required to use normalization in fixing subsidy rates, it estimates that the potential 1970–1974 subsidy could be $30 million in excess of the subsidy established using flow-through principles.

It is for these reasons that, as I stated earlier, the Board supports exclusion of air carriers from the scope of Subtitle F of H.R. 13270. These comments are being submitted in lieu of an oral presentation of the Board's views.

The Board has been advised by the Bureau of the Budget that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

JOHN H. CROOKER, Jr., *Chairman*.

STATE OF WISCONSIN,
PUBLIC SERVICE COMMISSION,
Madison, Wis., September 23, 1969.

Re Tax Reform Bill of 1969 House Report 13270.

Subtitle F—Depreciation Allowed Regulated Industries; Earnings and Profits Adjustment for Depreciation.

Section 451. Public Utility Property.

COMMITTEE ON FINANCE,
U.S. Senate, New Senate Office Building,
Washington, D.C.

GENTLEMEN: This written statement, presented in lieu of a personal appearance before the Committee, is for the purpose of suggesting a change in subsection 451(a)(5)(B)(ii) in H.R. 13270 to permit continuance of the Wisconsin method of normalizing the effects of liberalized depreciation on the accounting records of regulated public utilities in Wisconsin. The nature of and reasons for such modification are stated below.

Public utilities computing the amount of depreciation deduction for income tax purposes under section 167 of the Internal Revenue Code by the declining balance, sum of years digits or other methods different from the straight-line method, generally record on their books of record, as do most other taxpayers, depreciation expense computed by use of the straight-line method. Under these circumstances, recording of actual income tax liability results in an increase in the level of net income and, with other factors being equal, permits a reduction in the utility's rates for rendering service, thus resulting in an additional reduction in income tax payments by the utility.

Amendments to section 167, as reflected in section 451 of the Tax Reform Bill of 1969, (a) with respect to existing public utility property generally freezes the present situation and (b) for property completed after December 31, 1969, requires a normalization method by adjustments to a reserve for deferred taxes to reflect the reductions in income tax liability resulting from the use of methods of depreciation other than straight-line.

Increases in income from flow through treatment of liberalized depreciation benefits and associated reductions in rates for utility service further reducing income tax payments results directly from utility taxpayers recording lesser depreciation charges on their books than they take as deductions for tax purposes. The Public Service Commission of Wisconsin has recognized this as a depreciation problem since the enactment of liberalized depreciation provisions in section 167 in 1954. We have required public utilities using other than straight-line methods for Federal income tax purposes, to record as additional depreciation expense, the reduction in income taxes resulting from the use of such depreciation methods for tax purposes.

This procedure accomplishes the objective of the amendments in section 451 of H.R. 13270 with respect to protection of Federal income tax revenues and recognizes that a remedy of the problem is that of properly recording depreciation expense. The Wisconsin method therefore should, in our opinion, be recognized as an alternative in the normalization method of accounting set forth in section 451 (a)(5)(B)(ii) by a simple adjustment deleting the phrase "for deferred taxes" to read as follows:

"(ii) makes adjustment to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Wisconsin Commission requests favorable consideration of this change so that the Wisconsin method of reflecting normalization widely accepted by Wisconsin public utilities and acclaimed by many others may be continued in Wisconsin.

Respectfully submitted.

PUBLIC SERVICE COMMISSION OF WISCONSIN,
WILLIAM E. TORKELSON, *Chief Counsel.*

[Telegram]

WASHINGTON, D.C., *September 30, 1969.*

Senator CLIFFORD P. HANSEN,
New Senate Office Building,
Washington, D.C.:

The Transportation Association of America urges that section 451 of the tax reform bill, H.R. 13270, be amended to exclude oil pipe lines from the classification of public utilities. More specifically we ask that the oil pipe lines be exempted from straight-line depreciation requirements for public utilities as contained in Section 451 of the bill. They should be exempt as provided for airlines, highway, rail, and water carriers. Oil pipe lines are not a public utility. They are regulated by the Interstate Commerce Commission which also recommends such exemption. Oil pipe lines are a vital segment of the common carrier industry. Anyone can enter the common carrier pipe line business to compete with other pipe lines and other types of interstate transportation. They do not have a monoply. Shippers, investors, other modes of transportation, and government agencies, recognize oil pipe lines as an important segment of the transportation industry which transported 397 billion ton miles of petroleum products in 1968. Please include this telegram as part of record of hearings on H.R. 13270.

HAROLD F. HAMMOND,
President, Transportation Association of America.

STATEMENT OF DR. HOMER A. BLACK ON BEHALF OF THE UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION

SUMMARY

Purpose of statement

The purpose of Section 451 of H.R. 13270 is to assure that the original Congressional intent of the accelerated depreciation provision in Section 167 of the Internal Revenue Code is carried out. According to Committee reports, the faster tax write-off is intended to aid growing businesses in financing expansion and modernization by increasing available working capital.

Enactment of ths proposed legislation, Section 451, is vitally important to the 2,000 Independent telephone companies because accelerated tax depreciation can provide them about 10 percent of the funds they need annually—$140 million of the $1.4 billion total—to finance investment in new plant and equipment.

The Congressional intent of Section 167 of the Internal Revenue Code has been realized for non-regulated businesses, which have obtained substantial amounts of new capital by using accelerated depreciation for tax purposes. Regulated utilities are increasingly being denied by flow-through accounting or imputed flow through the use of funds which they obtain from accelerated tax depreciation.

One result of this trend to flow-through is to deny regulated companies money needed in financing the new plant and equipment necesasry to meet the accelerating demand for telephone services. Other results are the inequitable distribution of the benefits of accelerted tax depreciation between current and future customers, and the potential loss to the Federal Treasury of $1.5 billion annually in tax revenues.

Consideration by House Ways and Means Committee

The House Ways and Means Committee studied comprehensively the consequences of present practices under the accelerated tax depreciation provisions of the Internal Revenue Code. As a result, the Committee drafted Section 451 of the Bill now being considered so as to assure that the tax depreciation provisions will more effectively accomplish their intended working capital purposes.

Advantages of Section 451

Enactment of Section 451 is desirable because:

(1) It eliminates the $1.5 billion potential loss of Federal revenues expected if the current trend to flow through is continued.

(2) It requires no change in tax depreciation practices that will disrupt the existing rate structures of regulated utilities.

(3) It does not impair the authority of regulatory agencies to regulate the rates of accounting practices of utilities.

(4) It enables utility companies, with the consent of their regulatory authorities, to use funds from accelerated tax depreciation to finance new plant and equipment, just as non-regulated companies are now doing.

(5) It assures a more equitable distribution of the benefits of accelerated tax depreciation between present and future utility customers.

(6) It limits the extent to which regulated companies become dependent on continuation of accelerated tax depreciation measures, and protects the usefulness of these measures in promoting necessary economic development.

STATEMENT

Mr. Chairman, members of the Committee:

This statement is submitted at the request of the United States Independent Telephone Association to express support and emphasize the importance of Section 451 of H.R. 13270 to the Independent (non-Bell) segment of the telephone industry.

I am Professor and Chairman of Accounting at Florida State University. I hold a Ph. D. degree in Business Administration from the University of Michigan and am a Certified Public Accountant. I am the author of *Accounting Research Study No. 9*, "Interperiod Allocation of Corporate Income Taxes," published in 1966 by the American Institute of Certified Public Accountants. This study was the basis on which the Accounting Principles Board issued its opinion requiring normalization.

On March 26, 1969, I testified before the House Ways and Means Committee in support of proposed legislation designed to insure that the Congressional intent in providing for accelerated tax depreciation was carried out.

There are approximately 2,000 Independent telephone companies which serve more than one-half the geographical area of the nation, primarily in the smaller communities—the suburban and rural areas. The Independent telephone companies had 18 million telephones in service in 1968, representing a plant investment of almost $10 billion. For the past 10 years customer demand for the services of the Independents has grown at an average rate of 10.7 percent a year. This is almost double the rate of increase of the Gross National Product.

Last year the Independents were investing new capital at an annual rate of $1.4 billion to improve their services and to expand their plants and facilities. By 1970 the industry will have 20.8 million telephones in service, representing a total plant investment of $12.5 billion and consumer demand of $2.8 billion per year.

Depreciation is the largest single expense item of the Independent telephone industry. It amounts to approximately $425 million per year, which is 24 percent of the industry's total operating expenses and taxes. It is estimated that about 10 percent of the funds annually needed by the Independent telephone companies for plant investment might be derived from industry-wide use of accelerated tax depreciation. Because of the amounts involved, the enactment of the provisions of Section 451 of H.R. 13270 is most important.

THE PROBLEM

The following circumstances underlie the urgent need for Section 451 in the legislation adopted by the House:

SECTION 167 WAS ENACTED TO PROVIDE WORKING CAPITAL

When Congress passed Section 167 of the Internal Revenue Code in 1954, the Committee reports stated that "the faster tax write-off would increase available working capital and materially aid growing businesses in the financing of their expansion." (H. Report 1337 and S. Report 1622). The House report recognized that "the changes made by your committee's bill affect the timing and not the ultimate amount of depreciation deductions with respect to a property."

THE INTENT OF CONGRESS HAS BEEN ACHIEVED FOR NON-REGULATED BUSINESSES

Non-regulated businesses have increased their cash flow and thereby obtained the use of capital through adoption of accelerated tax depreciation in either of two ways:

(1) They have used accelerated depreciation for both book and tax purposes, or

(2) They have used accelerated depreciation for tax purposes, and straight-line depreciation for book purposes, and have normalized.

Normalization is an accounting procedure required by the accounting profession and the Securities and Exchange Commission for non-regulated industry. Under this procedure the amount of the taxes deferred by using accelerated tax depreciation is placed in a reserve for future payment. Thus, it is clearly recognized that accelerated tax depreciation results in a deferral of tax payment, not in a cost saving.

REGULATED BUSINESSES HAVE BEEN SUBJECTED TO DIFFERENT TREATMENT

Under rules established by regulatory agencies, utilities are generally required to use straight-line depreciation for book purposes. Although utilities using accelerated depreciation for tax purposes were initially permitted to normalize the deferred taxes, many are now being required to "flow through". Under "flow through" the funds provided by lower current tax payments resulting from the use of accelerated tax depreciation are erroneously treated as additions to net earnings after taxes, rather than correctly as a temporary source of working capital.

RECENT DEVELOPMENTS STRESS THE NEED FOR REMEDIAL LEGISLATION

(a) Action of regulatory bodies

In recent years, both Federal and state regulatory agencies have increasingly been adopting flow-through treatment. Some agencies that initially authorized normalization have reversed their policy and are requiring flow through. Thus, contrary to the intent of Congress, utilities are increasingly being denied the right to use working capital obtained through the use of accelerated tax depreciation benefitting consumers over a period of years.

Federal tax revenues that were intended by Congress for business investment are being diverted instead to subsidize only present utility consumers. Furthermore, in recent months some agencies have required utility companies to compute their earnings as if they had used accelerated tax depreciation, and to flow through to consumers the imputed tax benefits even though the companies had actually been using straight-line depreciation for tax purposes.

The increasing requirement of flow-through, and imputed flow-through, is of particular concern to the Independent telephone companies because it places them at a competitive disadvantage. They must compete with non-regulated industry to raise large amounts of capital, under current high interest rates, in order to provide the larger quantity and higher quality of services demanded by their customers.

(b) Loss of federal tax revenues

The Treasury Department advised the Ways and Means Committee that "If utility commissions generally proceed to treat companies as though they had adopted accelerated depreciation and require this amount to be flowed through, the total impact on (Federal) revenues, over the next few years, could build up to an annual loss of $1.5 billion."

COMPREHENSIVE CONSIDERATION BY THE WAYS AND MEANS COMMITTEE

The Ways and Means Committee devoted most of two days to hearing testimoney from and questioning 15 witnesses on the problems created by methods presently required in accounting for accelerated tax depreciation. These witnesses included representatives from four Federal regulatory agencies; a state public service commission; a national public accounting firm; and electric, gas and telephone companies; as well as economists and an investment banker. In addition, statements were filed by 14 others representing utilities, consumers, and regulators.

The testimony developed in detail the points of view of regulatory agencies, regulated utilities and others who are vitally concerned about the uneconomic and inequitable results of present practices under the existing provisions of Section 167 of the Internal Revenue Code.

SUMMARY OF SECTION 451, SUBTITLE F OF H.R. 13270

In drafting Section 451, the Ways and Means Committee reaffirmed that the use of accelerated tax depreciation results in a "deferral" of Federal income tax payments and not a "saving" of taxes. As drafted, the Section assures that accelerated tax depreciation provisions of the Internal Revenue Code will more effectively accomplish their intended purpose and prevent the unintended drain on Federal revenues.

The Section applies to property used in the furnishing of electrical energy; water; sewage disposal services; gas through a local distributing system; telephone services (excluding ComSAT); and transportation of gas, oil, or petroleum products by pipelines, if rates for these services are regulated by a utilities commission.

As to all such property constructed or acquired up to January 1, 1970, the following rules apply:

(1) If straight-line depreciation is presently used for tax purposes, then no other method is permitted;

(2) If accelerated depreciation is used for tax purposes, with "normalization," the utility must continue to do so unless it changes to straight-line; and

(3) If accelerated tax depreciation is used with flow-through no change is made.

As to new property (after December 31, 1969), the provisions are:

(1) If the taxpayer presently uses accelerated tax depreciation and flow-through, no change is made.

(2) In all other cases accelerated tax depreciation may be used only if the utility taxpayer normalizes the deferred income taxes.

The Section will permit any necessary changes in the methods used by taxpaying utilities, and authorized by regulatory commissions, in implementing the public policy to be made in an orderly way, without hardship to the utility consumer, the utility enterprise, or the Federal Treasury.

REASONS FOR ADOPTING SECTION 451

(1) *Section 451 will eliminate the potential $1.5 billion annual loss of Treasury tax revenue* that is expected to result from continuation of the current regulatory trend to require utilities to use accelerated tax depreciation with flow through. Section 451 will prevent adverse tax revenue effects with respect to existing property by prohibiting:

(a) A company which now uses straight-line tax depreciation from switching to accelerated tax depreciation.

(b) A company which now uses accelerated tax depreciation, and normalizes, from switching to flow through.

Adverse tax revenue effects will also be prevented by allowing only those taxpayers who are now using flow through to do so on property added after 1969. Even those companies may normalize if they receive regulatory approval.

(2) Section 451 requires no change in the existing use of tax depreciation methods by utilities that will disrupt the rate structures prescribed by regulatory agencies.

Section 451 does not infringe upon the present authority of regulatory agencies to regulate the rates or accounting practices of utilities under their jurisdiction. The authority of regulatory agencies to exclude a normalization reserve from the rate base in the same manner that depreciation reserves are excluded remains unaffected. By such exclusion the consumer receives the benefits of the use of the money. Thus, Section 451 amends the tax law merely to insure that the original intent of Congress is achieved.

(3) *Section 451 enables the original purpose of Congress—to provide working capital for all industries—to be accomplished for regulated firms as it is now being accomplished by non-regulated firms.* When the regulatory agency permits normalization accounting, a regulated company may us accelerated depreciation for tax purposes and thereby obtain the use of working capital as intended by Section 167 of the Internal Revenue Code.

(4) *Section 451 assures a more equitable distribution of the benefits of accelerated tax depreciation between present and future customers* of those utilities which normalize.

All customers benefit when a company normalizes because the company's cost of capital is reduced.

(5) *Section 451 protects the usefulness of an important measure of Federal tax and fiscal policy—accelerated tax depreciation*—in promoting necessary economic development. By limiting the use of flow-through for the future, this Section reduces the extent to which utility companies become dependent on continuation of these measures. If utility companies generally adopt the use of flow through, Congress would find it difficult to reduce or repeal tax provisions for accelerated depreciation regardless of the national policy requirement for such a change.

CONCLUSION

I wholeheartedly endorse the enactment of Section 451 as a means of accomplishing the original intent of Congress, reflected by Section 167 of the Internal Revenue Code, in an effective, equitable, and orderly manner. This Section substantially avoids the increasing drain on Federal revenues from existing practices, avoids infringing on the prerogatives of the regulatory agencies, and benefits utility customers and utility companies.

STATEMENT OF THE ASSOCIATION OF OIL PIPE LINES, SUBMITTED BY J. D. DURAND, GENERAL COUNSEL

SUMMARY

Section 451 of H.R. 13270 would have the effect of classifying oil pipelines, alone of all forms of transportation regulated by the Interstate Commerce Commission, as public utilities with guaranteed rates of return and "freezing" them in the methods of depreciation they are now using. With respect to the new pipeline companies which each year enter the ranks of the industry, section 451 would compel them to use straight line depreciation only. The Association of Oil Pipe Lines (AOPL), which is composed of substantially all of the oil pipelines regulated by the Interstate Commerce Commission, believes that such a classification is incorrect and improper for three principal reasons. First, the oil pipelines are not monopolistic utilities with guaranteed rates of return. They are in law and in fact true common carriers subject to strong competition from the water carriers (barge lines), the motor carriers and the railroads, the remaining forms of transportation regulated by the ICC. Second, all of the forms of transportation which compete with the oil pipelines have been excluded from section 451, and to leave oil pipelines subject to that section, contrary to the recommendations of the ICC, would result in a serious tax discrimination against them and in favor of their competitors. Third, the oil pipelines do not create for the Treasury Department a revenue loss problem from "flow through."

For these reasons, which have been set forth in detail in the following statement, AOPL urges the Committee on Finance to amend section 451 to exclude oil pipelines therefrom. This can be done by deleting from section 451, at lines 8 and 9, on page 268 of the bill, the words ", oil (including shale oil), or petroleum products."

STATEMENT

1. *Oil pipelines are in law and in fact true common carriers and there is "freedom of entry" into the oil pipeline transportation field.*

The oil pipeline companies are in law and in fact true common carriers. Insofar as the legal situation is concerned, they are, like the railroads, subject to Part I of the Interstate Commerce Act and thus come under the economic regulatory jurisdiction of the ICC although no certificate of public convenience and necessity or operating permit from the Commission is needed to enter the common carrier oil pipeline business. Pipelines are required to file tariffs covering their transportation of petroleum and petroleum products and strictly abide by those tariffs in all instances; their rates and charges to shippers must be just and reasonable; the transportation of petroleum and petroleum products must be performed under just and reasonable regulations and practices and no pipeline may grant unreasonable preference to any shipper or unduly discriminate among shippers in any way in connection with its services; transportation must be furnished to all shippers upon reasonable request therefor and reasonable through rates and services with other pipelines must be established; pipelines may not pool traffic, services or earnings except with the approval of the Commission, and all pipelines must keep their accounts and records in conformity with the Uniform System of Accounts for Pipelines prescribed by the ICC.

Oil pipelines serve simply as common carriers for all petroleum shippers who offer crude oil or petroleum products to them for transportation in accordance with the tariffs which the pipelines have on file with the ICC. *The oil pipelines do not buy or sell petroleum or petroleum products and they do not own the petroleum or petroleum products which they transport.* In this important respect they differ completely from the gas transmission lines. They also differ importantly from the electric, water and telephone companies since they do not sell products or services to the general public but only provide a mode of transportation to producers and refiners of petroleum.

Since, as stated above, a certificate of public convenience and necessity or operating permit is *not* required to enter the common carrier oil pipeline business, there is freedom of entry into this mode of transportation. Studies made by AOPL indicate that fourteen new oil pipeline companies have begun operations during the five and one-half year period since January 1, 1964. *Clearly therefore, transportation of oil by pipeline is not a monopolistic industry.*

2. *The common carrier oil pipelines are in direct competition with the inland water carriers (barge lines), the motor carriers and the railroads and should be treated in the same way as these competitors are treated with regard to permitted methods of tax depreciation.*

This Association annually compiles data showing the relative tonnage of petroleum and petroleum products carried in domestic transportation by the pipelines, the water carriers (barge lines), the motor carriers and the railroads. For 1967, the latest year for which data are available, and which is a typical year, the oil pipelines carried 45.64% of the total tons of crude petroleum and petroleum products carried in domestic transportation by the four modes specified. The motor carriers were second with 29.13%, the water carriers third with 23.50% and the railroads fourth with 1.73%. It can be truly said that competition from motor carriers and water carriers is significant since together these two modes carry more tonnage than the oil pipelines. While the pipelines are the principal mode of transportation of crude petroleum, the water carriers carry 18.79% of this commodity and the motor carriers carry 7.37%. With regard to petroleum products carried in domestic transportation, the oil pipelines carry 29.25% of the total tonnage, far short of the 41.87% carried by the motor carriers and only slightly more than the 26.26% transported by the water carriers.

These figures point up the correctness of the reference to "the existence of strong competitive forces" among the ICC regulated carriers referred to at the bottom of page 2 of the letter of April 15, 1969, to the Ways and Means Committee from the Chairman of the ICC (copy attached). It would be obviously unfair to permit, as section 451 contemplates, the water carriers, the motor carriers and the railroads to continue to have the right to select the method of depreciation most advantageous to them and to prevent the oil pipelines from exercising this choice.

3. *Subjecting oil pipelines to the provisions of proposed section 451 would be contrary to the recommendations of the ICC.*

The April 15, 1969, letter to the Ways and Means Committee from the Chairman of the Interstate Commerce Commission, to which reference was made above, urges that *all* modes of transportation regulated by the ICC be treated alike insofar as methods of tax depreciation are concerned. The letter refers to the strong competition which exists among the modes of transportation regulated by the ICC and the fact that (bottom of page 3 and page 4) "The interplay of competitive forces keeps the rate structure in a constant state of change" and that "in many cases where the Commission has permitted increases in the rates of a particular mode to take effect, competition from other regulated modes or unregulated transportation has subsequently forced reduction in these rates to prevent undue diversion of traffic to a competing mode of carrier."

The obvious conclusion from this letter is that all modes of transportation regulated by the ICC—the railroads, the motor carriers, the water carriers and the oil pipelines—should be treated alike with regard to such an important tax consideration as methods of depreciation.

This even-handed treatment for all modes of transportation regulated by the ICC is in accord with the National Transportation Policy set forth in the Interstate Commerce Act, which, in part, provides:

"It is hereby declared to be the national transportation policy of the Congress to provide for fair and impartial regulation of all modes of transportation subject to the provisions of this Act, so administered as to recognize and preserve the inherent advantages of each; * * *"

In connection with the review by the Committee on Finance of the scope of section 451, AOPL strongly recommends that the Committee consult with the ICC and determine its views with regard to the desirabiliy of including oil pipelines under that section.

4. *Unlike the rate procedures of the Federal Power Commission and the Federal Communications Commission, the ICC rate procedures do not and cannot result in prescribing levels of earnings for the carriers which it regulates and thus the oil pipelines do not have a guaranteed rate of return.*

To classify the oil pipeline transportation industry in the same category for treatment of accelerated depreciation as the gas, telephone, water and electric utility industries appears to involve a moral (and perhaps a legal) wrong, plus an economic monstrosity.

The Interstate Commerce Commission's processes in handling oil pipeline tariff rates are not in any way similar to the processes whereby the FPC, the FCC and state regulatory agencies establish and set rates for gas, electric, water and telephone utilities. Under normal rate procedures, these latter agencies make a determination of the rate level necessary to fix corporate net income at a permitted rate of return on an agreed rate base.

The ICC does not and cannot prescribe earnings for oil pipelines, barge lines. railroads and motor carriers as do the agencies that regulate true utilities since the ICC regulated carriers do not have monopolistic characteristics. The interplay of competitive forces assures that the rate structure will be in a constant state of change.

Distinguishing between oil pipelines and their transportation competitors by putting oil pipelines in a true utility category, in which they do not belong, was probably due to a msunderstanding by the Ways and Means Committee of the nature of oil pipeline transportation, and the Committee on Finance is urged to review carefully the attached letter from the ICC, particularly the following portion (commencing on page 4):

"In this regard, we should point out that in many cases where the Commission has permitted increases in the rates of a particular mode to take effect, competition from other regulated modes or unregulated transportation has subsequently forced reductions in these rates to prevent undue diversion of traffic to a competing mode or carrier."

This observation is particularly pertinent to oil pipelines since one of our principal competitors, the water carriers, enjoy freedom from rate regulation by the ICC in their transportation of petroleum and petroleum products.

5. *The oil pipelines do not create for the Treasury Department a revenue loss problem from flow through.*

Since oil pipeline rate are regulated more by competition than by regulatory agency determination, the rate level is not affected by flow through. There have been a few rate cases before the ICC affecting oil pipelines. Most of these cases involved only point to point rates and none involved flow through.

The problems that Treasury faces in loss of revenue through flow through of accelerated depreciation centers around the growing practice of regulatory agencies of forcing flow through to *residential* customers using gas, electricity, water and telephone services. It should be recognized that the customers of the oil pipelines are the corporate producers and refiners who buy and ship crude oil to refinery centers and in turn ship refined products to jobbers. If any flow through should occur from oil pipeline accelerated depreciation, it would go directly to other corporate taxpayers and, by reducing their operating costs, it would increase their Federal income taxes.

CONCLUSION

In view of the foregoing, AOPL urges the Committee on Finance to amend section 451 to exclude oil pipelines from the classification of public utilities subject to that section. From the viewpoint of even-handed justice and to prevent the tax discrimination which would result against oil pipelines as compared with their competitors, the oil pipelines should be treated similarly to the motor carriers, the water carriers and the railroads with respect to this important tax provision.

J. D. DURAND,
General Counsel, Association of Oil Pipe Lines

INTERSTATE COMMERCE COMMISSION,
Washington, D.C., April 15, 1969.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR CHAIRMAN MILLS: In the course of my testimony before the Committee on March 25, 1969, you and other members of the Committee requested that I provide certain additional information for the record regarding several aspects of the tax expenses incurred by carriers subject to the Commission's jurisdiction and our treatment of such expenses. The information requested is set forth below.

On pages 4210–12 of the hearing transcript, Congressman Burke requested information concerning (1) what taxes, if any, were owned to the Federal Government by the New Haven Railroad and by whom were they assumed; and (2) whether the Commission in its recent approval of Penn Central's request to increase fares reached its decision on the basis of the operation of the New Haven Railroad prior to takeover or if it was based on the anticipated revenue this year in view of the abandonment of 91 trains and other things before the Commission.

As to the first question, the New Haven Railroad had the following current tax liabilities due the United States Government at the time its operations were taken over by the Penn Central: $83,266 representing Federal income taxes of leased lines and $1,021,435 payroll taxes. Under the agreement Penn Central acquired certain current assets and assumed certain current liabilities, including $45,661 of the Federal income taxes and the $1,021,435 payroll taxes. The New Haven Railroad is to pay Penn Central in cash the excess of the liabilities over assets. We have been advised that the taxes in question were paid by Penn Central in January 1969. The remaining $37,604 of income taxes is still a liability of the New Haven.

We are unable to provide any information on the second question since the passenger fare increase proposed and put into effect by Penn Central was not applicable to passenger service performed over lines of the New Haven.

On page 4248 of the hearing transcript, you requested the views of the Commission with respect to effect on industries subject to our jurisdiction if Congress were to repeal the present provisions of the tax laws dealing with accelerated depreciation or were to otherwise deprive such industries "of anything other than straight line [depreciation]?"

As indicated in my testimony before the Committee, the regulatory problems with respect to maximum rates and earnings of regulated surface transportation carriers are not as significant for the Commission as they are for other agencies engaged in regulating other public utilities. This is largely due to the existence of strong competitive forces, both within the regulated portion of the industry and without, in the form of unregulated for-hire and private carriage. These strong competitive pressures generally serve to keep rates from exceeding a reasonable maximum level, thus minimizing the necessity for the Commission to prescribe a maximum rate level or otherwise intervene in the ratemaking process to the same extent required in the case of the regulation of industries with monopolistic characteristics. Because of these competitive forces, we do not believe that the denial of accelerated depreciation to regulated industries, as suggested by the Federal Power Commission (Testimony of Chairman White, Tr. p. 4131), would be in the best interests of the carriers subject to our jurisdiction or to the growth and development of an economically sound transportation system. In essence, it is our understanding that the position of the Federal Power Commission is premised on the concept that if additional stimulation is required for the attraction of capital in regulated industry, it is the responsibility of the appropriate regulatory agency to approve or to prescribe a level of rates sufficient to attract such capital rather than having such capital attracted through incentives in the tax laws. Put differently, the burden of attracting new capital into the regulated industry should fall upon the ratepayer rather than the taxpaying public as a whole. (Tesimony of Chairman White, Tr. p. 4123).

While the principle described above can be logically applied to industries having the monopolistic characteristics of those subject to regulation by the Federal Power Commission, this principle could not be applied with any precision in the regulated surface transportation industry where the interplay of competitive forces keeps the rate structure in a constant state of change. In this regard, we should point out that in many cases where the Commission has permitted increases in the rates of a particular mode to take effect, competition from other regulated modes or unregulated transportation has subsequently forced reductions in these rates to prevent undue diversion of traffic to a competing mode or carrier. As long as the transportation ratepayer has this wide choice of options among carriers, the suggestion of the Federal Power Commission could not be meaningfully applied to regulated surface transportation carriers. Given these circumstances, depriving regulated transportation carriers of the use of any method of depreciation, other than the "straight-line method" would result in undesirable effects on the carriers. It would decrease net income of carriers by the amount of additional taxes they would have to pay; assuming operations are profitable. This would reduce the amount of cash available for investment in new property, particularly needed freight cars, maintenance of plant and dividends, among other things. To replenish the cash used to pay additional taxes, it would seem that carriers would have no alternative but to seek relief through requests for increased rates, which, for the reasons mentioned above, might not accomplish the intended effect. Additionally, the immediate resultant decrease in net earnings and cash flow could affect the carriers' credit position and their ability to provide adequate service to the shipping public.

As long as Congress sees fit to provide liberal depreciation methods for tax purposes and the investment tax credit for industry in general, we feel the surface transportation industry should not be deprived of such benefits.

I hope you and the other members of the Committee will find this information helpful.

Sincerely,

(S) Virginia Mae Brown
VIRGINIA MAE BROWN,
Chairman.

STATEMENT BY ERNEST L. GROVE, JR., VICE PRESIDENT AND CHIEF FINANCIAL AND ACCOUNTING OFFICER, NORTHEAST UTILITIES

(Northeast Utilities is a utility holding company system operating in Connecticut and western Massachusetts. Its principal operating subsidiaries are The Connecticut Light and Power Company, The Hartford Electric Light Company, Western Massachusetts Electric Company, and The Holyoke Water Power Company.)

Northeast Utilities believes that Section 451 of the Tax Reform Bill is inappropriate tax legislation. First, we feel it is wrong to make regulatory accounting procedures determinative of income tax deductions. This Bill would deny the benefits of accelerated depreciation to those public utilities regulated by commissions which adopt the "flow through" method of accounting. Under this Bill, a utility company's deduction for depreciation, which is the largest single deduction most utilities have, would be controlled by accounting policies adopted by the regulatory commission. We believe that to permit policies and procedures of regulatory commissions to determine tax effects is a questionable precedent for the Congress to adopt.

Second, the requirements in Section 451(a)(2) and (3) of the House Bill for the actual use of flow through in establishing cost of service on and prior to July 22, 1969, in order to utilize flow through are too rigid and inflexible. They fail to recognize those situations where a regulated utility which was using accelerated depreciation had taken positive and concrete steps to change from normalization to flow through prior to such date but where such change had not yet been authorized or implemented.

As an example of the difficulties and anomalies that this section of the Bill in its present form will create, may I cite the situation in Massachusetts with respect to our subsidiary, the Western Massachusetts Electric Company. This Company has been utilizing an accelerated depreciation method on its tax returns. However, for rate-making purposes, it has been obliged by the Massachusetts Regulatory Commission to "normalize," that is, to charge the tax reduction as a current tax expense and reflect it in its rates to its customers. Since February 14, 1969, when hearings were ordered, the Massachusetts Department of Public Utilities has had under formal consideration and advisement a change in the accounting method required of regulated public utilities from "normalization" to the "flow through" method. At a hearing before the Department on March 20 of this year, Western Massachusetts Electric Company pledged to reduce its rates to its customers by an annual amount of at least $1,700,000 if the Department would permit the use of the flow-through method. Before the Department had had opportunity to act, the House passed the present Bill. Now Section 451 will prevent this rate reduction which the Company is desirous of making since a "flow through" accounting order in Massachusetts would automatically result in the denial under this Bill of the use of accelerated depreciation to the Western Massachusetts Electric Company.

We respectfully suggest that Section 451 be modified to provide for situations where the regulated public utility has, on or before July 22, 1969, taken steps to obtain authorization to adopt flow-through accounting. This would be only equitable since the proposed tax legislation was not the inducement for proposing the accounting change.

With respect to Section 452 of the Tax Reform Bill, we would urge that if the Congress feels corrective action is required in this area, then the situation should be approached with a phase-out method, as President Nixon originally proposed, rather than with an absolute cut-off for tax years beginning after June 30, 1972, as Section 452 is presently written. The effect of the absolute cut-off date would mean that Northeast Utilities, for example, might have a return of capital dividend of, say, 60 percent in 1972 which would abruptly become fully taxable in 1973. We believe this would have a serious detrimental effect on the market price of our common shares. Also, it should be pointed out, a phase-out method would increase Treasury revenues in the interim years.

WISCONSIN GAS CO.,
Milwaukee, Wis., September 24, 1969.

CHIEF COUNSEL, U.S. SENATE FINANCE COMMITTEE,
Washington, D.C.

DEAR SIR: Your telegram dated September 9, 1969 scheduled my appearance on Monday, September 29, at 10:00 A.M. to present an oral statement relating to the Tax Reform Bill of 1969. My appearance was as Chairman of the Wisconsin Utilities Association Task Force on the Bill.

As outlined in my telegram, my request for time to be heard was with particular reference to Section 451(a)(5)(B)(ii) of H.R. 13270.

Section 451(a)(2) permits a method of depreciation other than the straight-line method in computing taxable income only if the taxpayer used the "normalization method" of accounting as of July 22, 1969 and continues such use.

Section 451(a)(5)(B)(ii) provides that a taxpayer is considered as using the normalization method of accounting only if he—

"(ii) makes adjustments to a reserve for deferred taxes to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Public Service Commission of Wisconsin has, in effect, provided for such normalization method of accounting, but adjustments are made to reserve for depreciation rather than a reserve for deferred taxes. Accordingly, the intent of the proposed legislation is met and the inadvertent failure to recognize the Wisconsin method would be corrected if the paragraph were amended as follows:

"(ii) makes adjustments to a reserve for deferred taxes to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

This matter has been discussed with the staff of the Joint Committee on Internal Revenue Taxation and it is my understanding that there is no disagreement as to the suggested technical revision which would (1) accommodate the normalization accounting method of the Public Service Commission of Wisconsin, (2) satisfy the intent of the proposed legislation, (3) correct a technical deficiency in H.R. 13270 and (4) serve the public interest.

On this basis, I ask that this statement be made a part of the printed record of the Committee's proceeding as if read and, in deference to the demands on the Committee's time, my request for time to appear is withdrawn.

Thank you for the Committee's consideration and understanding of this matter.

Very truly yours,

ROBERT M. HOFFER.

AMERICAN TELEPHONE AND TELEGRAPH CO.,
New York, N.Y., September 24, 1969.

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

DEAR MR. CHAIRMAN: This statement is respectfully submitted on behalf of the Bell Telephone System in favor of the public utility tax depreciation provisions as set forth in Section 451 of H.R. 13270.

The report of the Committee on Ways and Means accompanying H.R. 13270 discusses the background and need for legislation along the line of proposed Section 451, and I will limit my comments to a summary of the highlights of this background as it affects A.T. & T. and its operating telephone companies.

Briefly stated, we are convinced that the proposal is in the best interests of our customers and the Federal Treasury. We believe this bill, which directly involves a matter of tax policy, has been well designed to accomplish its purposes and does not infringe on regulatory authority.

We are vitally interested in these provisions because, as a capital-intensive industry, the Bell System companies must invest—and recover through depreciation—large amounts for the replacement, modernization and expansion of communications plant to meet public demand for service. The Bell System construction program this year calls for expenditures of about $5.7 billion, with every indication that the need in 1970 will be greater.

PROPOSED REFORM PROVIDES WORKING CAPITAL IN ACCORD WITH CONGRESSIONAL INTENT

Section 451 of H.R. 13270 is a reform measure which will assure that the original purpose of Congress, when it authorized accelerated tax depreciation in 1954, will be carried out substantially for the regulated sector of the economy as it is being fulfilled in the unregulated sector.

The declared purpose of Congress in 1954, when it initially authorized accelerated tax depreciation under Section 167 of the Internal Revenue Code, was to make working capital available to all American industry—regulated as well as unregulated—to encourage modernization and expansion of industrial capacity. This purpose was clearly stated in the Congressional reports, including that of the Senate Finance Committee, accompanying the original enactment of Section 167.[1]

In the case of non-regulated industries the accelerated tax depreciation provisions of Section 167 operate as Congress intended and produce working capital

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[1] S. Rep. No. 1622, p. 26. See also H. Rep. No. 1337, p. 24 (83d Cong., 2nd Sess.).

for these industries in one of two ways. First a non-regulated company may use accelerated depreciation not only for tax purposes but also for book purposes and to reflect the effect in its earnings. When this is done, tax payments are lower, cash flow is increased and outside capital requirements are thereby reduced. Another way a non-regulated company can obtain working capital is to use straight-line depreciation for book purposes, accelerated depreciation for tax purposes and reflect the reduction in current tax payments in a reserve to allocate tax costs properly over the life of the property. This procedure is known as "normalization" and is required by the accounting profession and the Securities and Exchange Commission for all non-regulated industries when faster depreciation is used for tax purposes than for book purposes.

For a singificant number of regulated public utilities, however, the accelerated tax depreciation provisions of Section 167 have not been accomplishing their purpose. Since regulatory commissions generally require utilities to use straight-line depreciation for book purposes, only the second method mentioned above is available to public utilities that wish to obtain working capital in this manner. However, many regulatory agencies will not permit the "normalization" procedure which, as indicated above, is required by the accounting profession and the S.E.C. in the case of non-regulated industry. Rather, they require the utilities under their jurisdiction to use an exception to this procedure, known as "flow-through". Under "flow-through" the cash flow generated by accelerated tax depreciation can be used to subsidize rates charged to current utility customers rather than to create a reserve of working capital. When this occurs, the cash flow generated by the use of accelerated tax depreciation does not generate a source of capital that Congress intended to provide under Section 167.

Any short-term benefit to current utility customers from "flow-through" is at the expense of future utility consumers and impairs the financial position of utilities by burdening them with large amounts of unprovided-for costs. For these reasons, Bell System companies—even though they have had pressing and increasing needs for large amounts of capital to provide the communications needs of the country and have wanted to obtain capital by using accelerated tax depreciation—have to date used for tax purposes the same straight-line depreciation method prescribed by the F.C.C. for book and rate-making purposes.

In a time of rapidly expanding national need for utility services, accompanied by unprecedented demands for utility investment capital, Section 451 of H.R. 13270 will afford all present straight-line and present normalizing utilities the same opportunity as nonregulated industry to obtain working capital from the use of accelerated tax depreciation, thus enabling those utilities to compete on the same terms as non-regulated industry in the capital markets.

UTILITY CONSUMERS BENEFIT

Section 451 of H.R. 13270 also serves to assure in the case of present straight-line utilities—thus, including Bell System companies—and also in the case of present normalizing companies, that the full benefits of accelerated tax depreciation will go to customers both present and future.

There is a widespread belief that utility consumers are better off under flow-through than under normalization. The fact is, however, that the difference between flow-through and normalization, so far as utility rate payers are concerned, is simply which particular utility customers get the benefit and when. Flow-through treats the entire reduction in current tax payments as available to reduce rates to today's customers. But it has been demonstrated that utility revenue requirements—and thus rates charged utility customers—become greater after a period of time under flow-through than they would be under normalization. Flow-through, in sum, gives a windfall benefit to today's customers to the detriment of tomorrow's customers.

With normalization, on the other hand, there is a savings in capital costs to utility consumers because they do not have to pay interest or other charges for these capital funds used in providing utility service. Moreover, reduced demands on the money markets may tend to lower the costs of the remaining external financing requirements. Under Section 451, regulatory agencies would have full authority to see that the normalization reserve is used as cost-free capital, and that the full benefit of this cost-free capital is given to utility customers. If the Bell System companies could normalize, they have made it clear they would use the reserve for the benefit of customers, passing savings in capital cost on to customers over the entire period the working capital is used in their behalf. No Bell System customer would be called on to pay higher charges because the cash flow from accelerated depreciation had been used to subsidize rates of earlier customers; all Bell System rate payers would receive an increasing benefit as the cost of capital is reduced.

FEDERAL TAX REVENUES ARE PROTECTED AGAINST UNINTENDED LOSS

Section 451 of H.R. 13270, in addition, will tend to increase Federal tax revenue levels. The Report of the Ways and Means Committee estimates these increased tax revenue levels annually at $60 million in 1970, $260 million in 1974, and $310 million in 1979.

These increased tax revenue amounts derive directly from the effect of "flow-through" on utility Federal income tax payments. The result of "flow-through" in general, as pointed out by the House Report, is to double the Government's revenue reduction in the early life of plant when measured against that which is contemplated to result directly from granting accelerated tax depreciation allowances to industry. Normalization, largely, avoids this doubling effect.

As mentioned above, Bell System companies to date have used the straight-line depreciation method for Federal income tax purposes. However, regulatory and other pressures have reached the point where the Bell System no longer has any practical choice but to adopt accelerated tax depreciation. Moreover, some regulators are imputing accelerated tax depreciation with "flow-through" on companies even though the companies are in fact using straight-line tax depreciation. If legislation applying to present straight-line companies along the line of Section 451 of H.R. 13270 were not to be enacted, and Bell System companies were forced—as they inevitably would be by regulatory pressures—to adopt accelerated tax depreciation with "flow-through", the reduction in their tax payments for 1970 would be about $110 million (assuming accelerated tax depreciation is taken only on plant placed in service after December 31, 1969), or some $55 million greater than the estimated reduction in their tax payments under normalization for 1970. If legislation along the lines of Section 451 of H.R. 13270 covering present straight-line utilities were enacted into law, the Bell System companies would expect to take accelerated tax depreciation on plant added in 1970 and subsequent years with "normalization".

In our view the provisions of Section 451 of H.R. 13270 are in the public interest, and I urge that they receive the Committee's favorable consideration.

Respectfully yours,

A. L. STOTT,
Vice President and Comptroller.

STATEMENT OF FLORIDA GAS TRANSMISSION COMPANY, SUBMITTED BY E. P. SHANAHAN, VICE PRESIDENT AND TREASURER

SUMMARY

H.R. 13270, Section 451, bases the ability of a public utility to use accelerated depreciation in the future upon the filing of its Federal income tax return on or before July 22, 1969. The filing of the tax return is an inappropriate event to determine this question. The significant events to which the future use of accelerated depreciation should be related are either (i) the recording of income tax expense on the regulated books of account or (ii) the filing of rates with the appropriate administrative agency, as of the relevant date selected for such determination.

In the case of Florida Gas Transmission Company, the Internal Revenue Service granted the Company an extension of time to September 15, 1969 for filing its tax return for 1968, the first tax return of the Company which uses accelerated depreciation. Accordingly, this return was not filed until August 25, 1969. However, in August 1968, the Company had filed rates with the Federal Power Commission in reliance upon the use and flowthrough of accelerated depreciation on all property acquired subsequent to 1967. These rates, which have been in effect since February 16, 1969, were based upon a cost of service which included Federal income tax expense at a level approximately $1.6 million a year below what it will be unless the Company is permitted to use accelerated depreciation for tax purposes in 1969 and future years.

Several alternative amendments to H.R. 13270 are suggested at the end of the Written Statement.

STATEMENT

In its bill to reform the income tax laws, the House of Representatives has proposed certain amendments to Section 167 of the Internal Revenue Code which would restrict the right of a public utility to use accelerated depreciation. Section 451 of House Bill 13270 would require the use of straight-line depreciation on public utility property unless a different method had been on such property for the latest taxable year for which a return was filed on or before July 22, 1969.

In the case of Florida Gas Transmission Company, the proposed requirement of the House Bill that the applicable return be filed on or before July 22, 1969 would have what undoubtedly is an inadvertent result. On June 26, 1969, the Internal Revenue Service granted the Company an extension of time until September 15, 1969 to file its income tax return for calendar year 1968. Thus the Company's 1968 tax return, which will be the first to use accelerated depreciation, was not filed until August 25, 1969. Nevertheless, in August 1968, the Company irrevocably committed itself to the use of accelerated depreciation, with respect to property acquired subsequent to December 31, 1967, by filing rates with the Federal Power Commission in reliance upon the use and flowthrough of accelerated depreciation. These rates have been in effect since February 16, 1969, and will not realize a fair return for the Company without the use and flowthrough of accelerated depreciation on property acquired in 1968 and 1969 (amounting to approximately $90,000,000 of a total plant of approximately $350,000,000). Nevertheless, because for the year 1967 (the latest taxable year for which a tax return was filed on or before July 22, 1969) the Company used solely a straight-line method of depreciation, the Company would be required by the House Bill to remain on straight-line depreciation for all years subsequent to 1968. For the year 1968, however, the Company would be entitled to take accelerated depreciation since the Bill does not apply with respect to taxable years ending before July 23, 1969.

We submit that the crucial determination with respect to its method of depreciation for tax purposes is made by a public utility when it files rates based upon the use and flowthrough of accelerated depreciation and so calculates the income tax expense recorded in its regulated books of account. Once rates have become effective in reliance upon the use and flowthrough of accelerated depreciation for tax purposes, the utility, in effect, has irrevocably committed itself to this method of depreciation so long as those rates remain in effect. Accordingly, the tax reform bill should base the relevant date for determining the future use of accelerated depreciation upon the recordation of income tax expenses in the regulated books of account or the filing of rates with the appropriate administrative agency, instead of or in addition to the date its Federal income tax return was filed.

The following evidences the fact that Florida Gas Transmission Company had decided to take accelerated depreciation during 1968, a year prior to the June 22, 1969 cut-off date presently in the House Bill. On June 17, 1968, the prepared direct testimony of Mr. W. J. Bowen, President and Chief Executive Officer of the Company, was filed with the Federal Power Commission and was formally introduced into evidence on July 18, 1968 at Volume No. 47, page 5923, in rate proceedings RP68–1 and RP66–4. Mr. Bowen stated that:

"If we are to achieve the rate objectives I have outlined, that is, to produce rates as low as or lower than the 17.9, 21.9 and 57.0 cents per MMBTU rates which we are collecting prior to the in-service date of the CP65–393 facilities exclusive of the surtax and to do so without seriously impairing the Company's financial integrity and competitive position, there is but one course open to us. We must accept the risks inherent in reducing our current revenues by deferring to a later period a part of our tax costs with the concomitant lowering of our financial debt coverages. We must elect to take liberalized depreciation on the CP65–393 facilities and on future plant additions. Therefore, I have asked our people to prepare the testimony and exhibits for the new rate filing on this basis and to request the necessary authorization to reflect 'flow through' accounting on those facilities."

On August 1, 1968, the Company made the new rate filing based upon the use of accelerated depreciation with respect to all property acquired subsequent to 1967. The relevant exhibits filed with the Federal Power Commission demonstrating this election are attached hereto as Schedule A. Since August 1, 1968, the Company uniformly has used accelerated depreciation with respect to property acquired subsequent to December 31, 1967 in calculating the income tax expense recorded in its regulated books of account. Since the rates filed on August 1, 1968 were based upon a cost of service which resulted from utilizing accelerated depreciation, thus flowing through the tax reductions to the customers in the form of lower rates, the rates would not provide the Company a fair return if depreciation based upon a straight-line method is required in determining taxable income for 1969 and subsequent years.

The rates filed on August 1, 1968 were allowed by the Federal Power Commission to become effective on February 16, 1969 and have remained in effect until the present time. A rate increase to reflect the unavailability of accelerated depreciation could be delayed by the administrative process for up to nine months after the decision to file the increased rates. From February 16, 1969 until new rates are permitted to become effective, the Company would have suffered a non-recoverable loss of approximately $1,600,000 annually because of its reliance upon the use and flowthrough of accelerated depreciation as described above.

As further evidence that the Company had elected to take accelerated depreciation during 1968, we attach hereto the following:[1]

1. Annual Report to stockholders of Florida Gas Company for the year 1968. Note (3) to the Notes to Financial Statements at page 21 states that:

"Concurrent with the completion in 1968 of its 192,000 MCF per day expansion, Florida Gas Transmission Company elected to claim liberalized depreciation for Federal income tax purposes on new facilities and to flow through the tax reductions to ratepayers, following an accounting method approved by the Federal Power Commission. Since there was a concurrent rate reduction, this change in accounting had no appreciable effect on net income for 1968."

In its report on page 22 of the Annual Report, Arthur Andersen & Co. states that the accounting principles:

". . . other than for the flow-through of the tax reductions from using liberalized depreciation as described in Note 3, were applied on a consistent basis during the two years [1967 and 1968]."

2. Prospectus, dated April 10, 1969, with respect to the sale of Florida Gas Company's 5¾% Convertible Subordinated Debentures due April 1, 1989 wherein Florida Gas Company and Arthur Andersen & Co. make similar representations on pages 8, 14, 29, and 35 to those made in the Annual Report of Florida Gas Company.

3. Form 10-K, dated April 30, 1969, filed with the Securities and Exchange Commission, containing statements identical to those in the Annual Report of Florida Gas Company.

In addition, on December 13, 1968, the Company filed its Amended Declaration of Estimated Income Tax for 1968 on the basis of depreciating its properties acquired subsequent to December 31, 1967 at accelerated rates for tax purposes. Also, registration statements filed with the Securities and Exchange Commission in May 1969, with respect to the Florida Gas Company Employees Savings Plan and the Florida Gas Company Qualified Stock Option Plan, contain statements with respect to accelerated depreciation similar to those contained in the Annual Report of Florida Gas Company.

For the above reasons, Florida Gas Transmission Company requests that subsection 167(k)(1)(A) of the Internal Revenue Code, as proposed to be amended by Section 451(a) of House Bill 13270, be amended in one of the following manners:

1. Delete subsection (1)(A) and substitute the following:

"(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer used a method other than the straight-line method in the calculation of income tax expense recorded in his regulated books of account for his latest monthly accounting period ending on or before July 22, 1969."

2. Delete subsection (1)(a) and substitute the following:

"(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer (*i*) for his latest taxable year for which a return was filed on or before Juyl 22, 1969, used a method other than the straight-line method, *or (ii) was, on July 22, 1969, collecting rates pursuant to rate schedules filed with a state or federal agency established by using a cost of*

[1] The attachments referred to are made a part of the official files of the Committee.

service which included tax expense computed by using a method other than the straight-line method and used a method other than the straight-line method in his Federal income tax return for his latest taxable year ending on or before July 22, 1969." (Changes underlined.)

3. Delete subsection (1) (A) and substitute the following:

"(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer (*i*) for his latest taxable year for which a return was filed on or before July 22, 1969, used a method other than the straight-line method, *or* (*ii*) *had filed, on or before July 22, 1969, rate schedules with a state or federal agency wherein rates were established by using a cost of service which included tax expense computed by using a method other than the straight-line method and used a method other than the straight-line method in his Federal income tax return for his latest taxable year ending on or before July 22, 1969.*" (Changes underlined.)

4. Delete the date "July 22, 1969" and substitute the date "September 15, 1969" therefor.

5. Delete the words "for which a return was filed" and insert in lieu thereof the word "ending" so that subsection (1) (A) would read as follows:

"(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer for his latest taxable year ending on or before July 22, 1969, used a method other than the straight-line method, and".

6. Delete the word "filed" and insert in lieu thereof the words "intially due" so that subsection (1) (A) would read as follows:

"(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer for his latest taxable year for which a return was intially due on or before July 22, 1969, used a method other than the straight-line method, and".

7. After the words "for which a return was filed on or before July 22, 1969" add "or on or before a subsequent date if a valid extension to file at such later date had been granted on or before July 22, 1969", so that subsection (1) (A) would read as follows:

"(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer for his latest taxable year for which a return was filed on or before July 22, 1969, or on or before a subsequent date if a valid extension to file at such later date had been granted on or before July 22, 1969, used a method other than the straight-line method, and".

APPENDIX C

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF INTEREST DEDUCTIONS

33-865—69—pt. 5——68

Written testimony received by the committee expressing an interest in the subject of interest deductions

ARTHUR ANDERSEN & Co.,
Chicago, Ill., September 19, 1969.

Re statement regarding H.R. 13270, Tax Reform Act of 1969—limitation on deduction of interest.

Mr. TOM VAIL,
Chif Counsel, Committee on Finance,
New Senate Office Building, Washington, D.C.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

DEAR MR. VAIL: The provision (Section 221), relating to limitations on the deduction of certain interest, should be deleted, in accordance with the recent recommendations made by the Treasury.

BASIS FOR COMMENTS

Our conclusions are based on the following:

(1) Portions of certain taxpayers' interest will already be subject to disallowance under Section 301 dealing with the general allocation of deductions. Providing for further disallowance under this Section creates a penalty provision.

(2) The Bill only relates to "investment interest," which is only defined as that interest paid on debt incurred or continued to purchase or carry property held for investment. On close analysis, this definition provides for a subjective test which will be virtually impossible to administer.

(3) Disallowance of interest on present debt would have a retroactive effect because it would unfavorably alter the economic rate of return on investments previously made, which were entered into on the basis of fixed commitments and the present tax law.

(4) In addition to the limitation at the individual level, a separate $25,000 limitation imposed on each partnership and Subchapter S corporation is not justified. Such a proposal would not take into consideration the size of the partnership or corporation, its investment, or the number of partners or shareholders. There is no economic basis for imposing such a harsh rule on investment property held by a partnership or Subchapter S corporation and many such entities would be forced to liquidate.

CONCLUSION

This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and recommendations contained herein be made part of the record of testimony relative to the legislative changes contemplated for limitation on deduction of interest. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

ARTHUR ANDERSEN & Co.,
By JOHN MENDENHALL,
Director of Taxes.

CHRYSLER REALTY CORP.,
September 29, 1969.

Re H.R. 13270—The Tax Reform Act of 1969
Subject Section 221—limitation on deduction of interest

COMMITTEE ON FINANCE,
U.S. Senate, New Senate Office Building,
Washington, D.C.

GENTLEMEN: Chrysler Realty Corporation hereby presents its views on Section 221 of H.R. 13270 dealing with the limitation on the deduction of funds borrowed to acquire or carry investment funds.

Under Section 221 of the bill, a limitation would be imposed (in the case of *non-corporate* taxpayers) on the deduction of interest on indebtedness incurred or continued to purchase or carry property held for investment. Investment interest in excess of the aggregate of (i) $25,000, (ii) net investment income and (iii) net long-term capital gains would be disallowed as a deduction.

Although the language of Section 221, as well as the House Report and the Supplemental Report thereto, clearly indicates that this limitation on certain interest deductions is aimed exclusively at *individuals*, one of its subparagraphs (Section 221(a)(4)(A)) would create an *unintended tax problem* for corporate taxpayers. This provision states that, in the case of partnerships, the limitation on the deduction of interest would apply at *both* the partnership and partner level. Hence, the partnership deduction would be limited to $25,000, and the partners, corporate as well as individual, would be limited to their proportionate share of the reduced interest deduction of the partnership.

Chrysler Realty Corporation sometimes enters into real estate ventures with one or more individuals, on a partnership basis. These ventures are part of Realty's regular business operations and it should not be faced with a potential interest disallowance from conducting an operation or transaction through a partnership which penalty would not be incurred had such operation or transaction been handled solely by Realty.

The unreasonable result could easily be remedied by applying the interest limitations at the individual partner level only. It should be noted that a similar approach is employed with respect to another partnership deduction, the charitable deduction. The latter deduction flows through intact from the partnership to the individual partners, in accordance with their respective distributive share, and the percentage limitation on such charitable deductions is then applied at the individual taxpayer's level.

Very truly yours,

E. A. SIGLER,
Vice President.

STATEMENT SUBMITTED BY GEORGE B. KILBORNE, BIRMINGHAM, MICH.

I would like to express my concern with Section 221 of H.R. 13270, the Tax Reform Act of 1969, which would limit the deduction of interest incurred on funds borrowed to acquire or carry investments. My concern is both general and specific in nature. My general concern is that this section proposes to limit out-of-pocket interest payments because they are made by an investor rather than in the course of a "trade or business" (as implicitly construed to exclude investors); this, in my view, is a questionable distinction. More specifically, I am concerned that this limitation on the deduction of interest would serve as a disincentive to investment motivated transactions, thereby raising serious questions as to the continuing availability and vitality of venture capital in our economy.

I would urge that in view of the negative results this provision would produce in the entrepreneurial and investment sectors of the economy, serious consideration be given to deletion of this provision. Alternatively, I would urge the Committee to adopt a venture capital exception so that interest paid with respect to investment motivated transactions represented by substantial equity participations would not be subject to the limitation on the deductibility of interest. It is also submitted that equitable application of this limitation suggests consideration be given to certain technical changes in order to provide flow through treatment in the case of partnerships and prospective application of the section.

Section 221.—Section 163(a) of the Internal Revenue Code provides that "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Section 221 of H.R. 13270 would amend Section 163 to deny "investment interest" deductions for taxable years beginning after December 31, 1969 to individuals and other noncorporate taxpayers to the extent such interest exceeds the sum of: (1) $25,000; (2) "net investment income"; and (3) the excess of net long-term capital gain over net short-term capital loss for the taxable year. "Investment interest" is defined as that interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. "Investment income" is defined as the gross amount of interest, dividends, rents, royalties, and net short-term capital gains derived from property held for investment and not derived from the conduct of a trade or business. The term "investment expenses" includes all deductions allowable under Sections 164(a)(1) or (2), 166, 167, 171, 212, or 611 directly connected with the production of investment income. The term "net investment income" means the excess of investment income over investment expenses.

Statutory Objectives.—In support of the interest limitation, the Report of the Committee on Ways and Means states, "Your committee does not believe it is appropriate to allow an individual taxpayer to currently deduct interest expense on funds borrowed for investment purposes where the interest expense is substantially in excess of the taxpayer's investment income."

The basic assumptions which in the Committee's view appear to underlie this statement (and the interest limitation generally) are:

(1) A taxpayer who is motivated by investment rather than tax considerations is generally interested in investments which produce a profit after taking interest expense into account;

(2) since interest is a controllable expenditure, it usually isn't necessary for a taxpayer to borrow substantial amounts for investment purposes, and, therefore, interest is a controllable expenditure; and

(3) taxpayers who incur interest expense substantially in excess of investment income are primarily interested in mismatching income and expenses so as to insulate their other income.

Assumptions Questioned.—Each of the assumptions stated above are subject to question:

(1) *Interest in Excess of Current Investment Income Equals Tax Motivation.*—There are few, if any, situations which permit an investor an opportunity to borrow funds and invest them at a current return equal to or greater than the interest cost on his borrowings. Furthermore, the fact that an individual is willing to make an investment and to seek eventual dividends and capital appreciation in the future, while incurring current interest expense, does not imply that such investment was solely motivated by tax considerations rather than bonafide efforts to achieve a profit from his investment.

(2) *Interest as a Controllable Expenditure.*—The Committee's assumption that it usually is not necessary for a taxpayer to borrow substantial amounts for investment purposes excludes a large segment of potential investors who are considered necessary to the functioning of the free enterprise system. This group consists of developers of large real estate projects, potential purchasers of new issues, investors in small businesses and new industries, and investors seeking to motivate better management.

(3) *Mismatching of Income and Interest Expense.*—While recognizing that there may be some mismatching of investment income and expense in order to insulate other income, I disagree that such mismatching is the primary motivation for all investments which may result in interest exceeding income for a given year. The very heart of the investment sector is the element of greater future return and appreciation on current investment. As a result, current investment income in the early years of investment seldom equals or exceeds investment interest.

Venture Capital.—The venture capitalist specifically belies the basic assumptions stated by the Ways and Means Committee in support of the interest limitation. The venture capitalist incurs interest on borrowing used for investments which are "investment" rather than "interest deduction" motivated. He is personified by the individual who has been successful in other areas and now wishes to apply his entrepreneural expertise in the risk capital area by acquiring substantial equity interests and participating in the management thereof. By definition such investments are not without risk and may involve two, three, four or five losses prior to hitting a winner.

A venture capitalist is not interested in the marginal profit involved in borrowing to invest in assets with a high current yield and low potential appreciation. Nor would he liquidate existing low-risk investments to generate funds for higher risk investment when such action would result in capital gains tax and a limitation on his deduction of investment interest. The mismatching of income and expense is even more pronounced with regard to the venture capitalist who acknowledges the time lag involved in turning risk investments into profit situations but is prepared to accept this medium term lag in anticipation of greater long term appreciation and investment income. To say that such mismatching of income and expense and the resultant presumed tax benefits is the primary motivation misjudges the role of the venture capitalist: this is especially true since the carrying costs of interest are real negative cash outlays detrimental to the taxpayer.

Disadvantages of the Interest Limitation.—In my view, the limitation on the deduction of interest imposed by the House Bill is a disincentive to venture capital, discriminates against earned income, favors incorporation, and ignores economic realities:

(1) *Disincentive to Venture Capital.*—The House Bill fails to recognize the legitimate and essential role of venture capital in our free enterprise system by serving as a clear disincentive to risk investments by those venture capitalists operating as individuals or through partnerships who are best equipped to provide the seed money that is so essential to our continuing prosperity. Even today, there is a substantial equity capital gap between the demand for equity capital in our economy and the available supply. This gap is widening. The limitation on the deduction for interest would serve as a further deterrent, possibly widening the equity capital gap to such an extent that Federal financing assistance would become necessary. This is contrary to the stated Federal policy which continually seeks to have the private sector provide venture capital.

(2) *Discriminates Against Earned Income.*—I agree with Assistant Secretary Cohen's statement of September 4 that the interest limitation "discriminates against the taxpayer who has only earned income out of which to pay his interest expense." That is, the taxpayer with investment income is permitted a deduction for investment interest, but the taxpayer with earned income is denied the deduction. In the same context, it favors the taxpayer with inherited or established wealth and discriminates against the "self-made" taxpayer with substantial earned income. Let me also suggest that the $25,000 exclusion or allowance, which permits an investment interest deduction to this extent and apparently reflects partial recognition of the need for equity capital, would deny interest deductions to larger risk capital investors except to the extent of invesment income. Such denial could result in creating large stagnant pools of capital, capital which should not remain in place but rather should be put out to productive work.

(3) *Favors Incorporation.*—By placing a limitation on the interest deduction of individuals and partnerships, the House Bill provides preferential treatment to corporations which borrow to acquire investment assets (the proposed amendments relating to the issuance of certain debt to the shareholders of acquired corporations notwithstanding). In other words, corporations could continue to borrow to finance acquisitions of investment assets totally unrelated to the business in which they are presently engaged and offset the borrowing costs against income derived from their other activities. This favors incorporation and distorts the traditional freedom of choice as to form of business organization.

(4) *Ignores Economic Realities.*—Although there may be abuses with respect to the deductibility of interest under existing law, it must be stressed that most investments made by individuals and partnerships are not tax motivated. The magnitude of the interest deduction, its relationship to the degree of investment income, and its label as a "controllable" expenditure—none of these factors either individually or in the aggregate automatically lead to a conclusion that tax abuse must be present. Venture capital involves risk investment which may appreciate or depreciate; interest paid is an out-of-pocket expense incurred whether or not the investment bears fruit or withers. Not all investments in low yield stocks are tax motivated. The use of borrowings to make investments is an accepted financing pattern and not just a tax gimmick. The time lag in many investments between start-up, break-even point, and dividend payment date is frequently long-term.

Recommendation.—Accordingly, it is urged that the Treasury Department's recommendation to delete the interest limitation be accepted by the Senate Finance Committee.

Venture Capital Exception.—If, however, the Committee considers the enactment of some limitation necessary to curb tax motivated investments, an exception should be adopted for investment motivated transactions representing direct rather than portfolio investments. Precedent for such a distinction is found in the "direct investment" exception to the interest equalization tax, where the equity investment is so substantial that it is considered as represening a management interest in the future profitability of the corporation. Such an exception, applying to investments involving a specified voting interest whether held individually or in investment partnership with others, would implicitly recognize the "trade or business" role of venture capitalists and provide a continuing and needed outlet and vitality for risk capital.

I would suggest that investments of venture capitalists are distinguishable from pure portfolio investments. The latter investments are most frequently made in established enterprises through registered national securities exchanges; they usually involve a nominal investment without management participation, and can be freely traded in an established market. On the other hand, venture capital involves a substantial equity participation and commitment, often in a small new business, with the management expertise of the investors being a key reason for the investment and for its later success. Such investments frequently have no established market; certainly where investors join in a venture capital partnership to make the investment, the transferability and marketability of the partners' interests (both general and limited partners) are severely restricted. Such investors do not generally participate in such investment partnerships because of the availability of a tax deduction or because of capital gain benefits; their investments are "investment", not tax, motivated. The general partners take meaningful equity participations and are directly and without limitation subject to the full risks of the partnership.

I would, therefore, urge the Committee to consider a venture capital exception where a substantial equity investment, say at least 5 to 10 percent of the underlying investment, is made either by an individual directly or in conjunction with others through a partnership. In the case of a partnership, the Committee may wish to consider additional limitations, based on the partner's percentage capital and profits interest in the partnership. A sliding scale as to amount of investment and percentage of ownership could be introduced if the Committee considers it desirable.

Technical Changes.—It is submitted that other changes, denominated as "technical" but which would remedy substantially adverse and apparently unintended effects of the limitation in its present form, should be seriously considered.

(1) *Partnerships.*—If the intent of the interest limitation is to permit the investment interest incurred to offset investment income, it is essential that a partner's pro-rata share of both net investment income and investment interest be fully attributed to him. In other words, if an individual has invested through two partnerships, one of which has net investment income substantially in excess of investment interest expenses and the other partnership has investment interest expenses substantially in excess of net investment income, the full amount of the partner's share of both net investment income and investment interest expense should be flowed through in the case of each partnership in order to achieve an equitable result and conform with the apparent intent of the proposed Bill.

This result is not achieved under the House Bill which requires that the limitation be applied both at the partnership level and at the partner level. The inequitable results of this bi-level approach (which appears to apply an entity theory to the partnership for some purposes and a flow-through approach for other purposes) are obvious and should be corrected.

(2) *Carryover.*—If the carryover of excess interest disallowed is to achieve its apparent purpose, that is to defer deduction for investment interest expenditures until there is adequate offsetting investment income, the term of the carryover should be substantial. This is based on the very nature of risk investments, and the time lag involved before new risk enterprises start paying dividends. It is presumed that the statute contemplates an unlimited carryover as to time but it would be reassuring to have this clarified.

(3) *Effective Date.*—The limitation on interest deduction contained in the House Bill would be effective for taxable years beginning after December 31.

1969. It would limit the deduction for investment interest expense regardless of when indebtedness was incurred. It is submitted that past investments have been based on existing law which permits an unlimited deduction for interest and that any limitation on investment interest should apply prospectively only to interest paid on indebtedness incurred after its enactment. Retention of the present effective date would unduly discriminate against those taxpayers, particularly venture capitalists, who made their outstanding investments within the context of long-standing, existing law.

Summary.—In summary, it is respectfully submitted that the Committee should delete the limitation on the deductibility of interest. Alternatively, it is recommended that an exception be enacted to preserve the viability of venture capital in our free enterprise system. Finally, it is submitted that flow-through treatment for partnerships and prospective application of the limitation are necessary to achieve an equitable result.

KINDEL & ANDERSON,
Santa Ana, Calif., September 26, 1969.

Re comments on sections 221 and 412 of H.R. 13720.

COMMITTEE ON FINANCE,
U.S. Senate,
Washington, D.C.

GENTLEMEN: On behalf of many of our interested clients, the law firm of Kindel & Anderson respectfully submits comments which we believe are of importance to your Committee on Sections 221 and 412 of H.R. 13720, the Tax Reform Bill of 1969.

While there are many portions of H.R. 13720 which are of concern to us and should be of concern to the general public, we believe that the Committee will receive adequate exposure to these problem areas from other interested individuals, groups, and businesses. We will, therefore, confine our observations to section 221, dealing with limitations on the deductibility of interest, and that portion of section 412 which would impose new rules on the election of the installment sale method of reporting the gain on the sale of personal or real property. These sections of the Bill otherwise may be overlooked since they will primarily affect individual taxpayers who, as a group, may not receive effective representation before your Committee.

I. Section 221

Section 221 would amend section 163 of the Internal Revenue Code by limiting the now unrestricted right of a taxpayer to deduct interest paid or accrued during the taxable year. The purpose of section 221, according to the House Ways and Means Committee Report, is to restrict the discretionary payment of interest by limiting the deduction available for "funds borrowed for investment purposes where the interest expense is substantially in excess of the taxpayer's investment income." H.R. Rep. No. 91–413, at 72.

Without arguing the policy underlying the stated purpose, we submit that the section will not accomplish its avowed purpose. It will not markedly limit the tax shelter availability of an interest expense for wealthy taxpayers, but rather will represent a drastic and unexpected burden on middle income taxpayers, and by reason of its complexity and confusing draftsmanship, it will present a host of interpretive problems for the Internal Revenue Service and the courts.

A. RETROACTIVE EFFECT

The limitations of section 221 would apply to all individuals, partnerships, and Subchapter "S" corporations by limiting the amount of "investment interest" which could be deducted in any one year. It would become effective for taxable years beginning after December 31, 1969, as to all indebtedness interest "incurred or continued to purchase or carry property held for investment." This means that the section would apply not only to indebtedness incurred after December 31, 1969, but also to indebtedness which was created prior to that date and as to which the taxpayer had become legally obligated to pay interest.

Even though Congress possesses the power to enact retroactive tax statutes, it has shown reluctance to do so in the past. For example, in 1917 the Senate Finance Committee rejected a House proposal to levy an additional tax on 1916 income for the purpose of financing the hevay costs of World War I. The Committee gave as its reasons:

"This [retroactive] tax seemed to the committee to be in principle both morally and economically unsound and to deserve exclusion as retroactive legislation. . . . Moreover, it is to be remembered that if we admit the principle of retroactive taxation running back six months we also assert the right to carry it back for one or ten years, or for any length of time. To do so this would hold out a threat of uncertainty in tax conditions, and almost the greatest foe of business productivity and prosperity is uncertainty. For these reasons the committee had no doubt as to the wisdom of striking from the bill the retroactive tax on incomes. . . ." Senate Report No. 103, 65th Congress, 1917.

Another example of Congressional reluctance to give retroactive effect to changes in the Internal Revenue Code came up in connection with the 1950 revisions of the formula for taxing life insurance companies. The Senate Finance Committee felt it inadvisable to apply the changes retroactively to the years 1947 and 1948 since to require the payment of a tax for those years could impose a hardships upon policyholders. Senate Report No. 2375, 81st Congress, 39 (1950). The Senate Report stated:

"The imposition of a tax on 1947 and 1948 incomes at this late date would be inconsistent with the fundamental public policy which requires that a taxpayer's obligation to his Government be made definite and certain at the time the tax is due." *Id.* at 39–40.

We feel that the application of the limitation on interest deductions to existing contracts would unfairly penalize taxpayers who, when incurring the indebtedness in prior years could not possibly foresee the disallowance of these legitimate business expenses. To change the rules as they apply to existing contracts, substantially diminishes the after-tax income of these taxpayers simply because they chose to borrow money for investment. If the purpose of this section is to curb voluntary assumptions of indebtedness for investment property, then at the very least, it should apply to future transactions contracted for after the effective date.

B. RENTAL INCOME

The language of section 221 is ambiguous and often conflicting. For instance, "investment income" is defined to include rents and interest (among other things) which are not "derived from the conduct of a trade or business." The words "trade or business" are words of art stemming from the capital asset definition of section 1221 of the Code. We know, from the administrative and judicial interpretations of section 1221, that a taxpayer may have more than one trade or business . A practicing doctor may invest in apartment buildings and this activity may become a separate trade or business. He may also, for example, purchase and sell loans secured by junior encumbrances at discounts which also may become a separate trade or business. The rent or interest from these types of activities would not come within the section 221 definition of investment income.

On the other hand, allowable investment interest which is limited to $25,000 plus the amount of investment income and net long-term capital gains, is that interest which is paid or accrued on property "held for investment". It is well known under present tax laws that a taxpayer may hold property for investment in his trade or business. A real estate developer may acquire rental property for investment while buying and selling real estate in his trade or business. In this situation, section 221 would have the effect of limiting the amount of investment income available for offset against investment interest from the same asset since the asset is held for investment, but as a part of the taxpayer's trade or business.

Further, the section would define all rental income to be income from a trade or business and, therefore, not "investment income", unless the rental income results from a "net lease". A net lease is defined as one where the Code section 162 ordinary business deductions are less than fifteen per cent of the "rental income" and there is a guarantee of a fixed return or against loss of income.

Applying these provisions to a typical example illustrates the ambiguities of the section. Assume X owns land and an office building which he leases to Y for a negotiated amount of rent. Y is required by the terms of the lease to pay the taxes and utilities and to maintain the building. X remains liable on a mortgage which was incurred to acquire the property and as the owner, is entitled to the depreciation on the property. By the terms of the lease, Y is contractually obligated to pay X a fixed monthly rent based upon their estimate of a fair return on the property. This would fit the classical pattern of a net lease. To apply section 221 to this transaction, the first test is whether "the sum of the deductions with respect to the rent-producing property which are allowable under section 162 (relating to trade or business expenses) equals or exceeds fifteen per cent of the rental income produced by such property. . . ." Is this fifteen per cent test to be applied as to the rental income received by X, or is it the total rental income from the entire property? Also, whose section 162 deductions are we talking about? Are these the deductions of the owner or are they the deductions relating to the properly as a whole? If they are the deductions relating to the property as a whole, the net lease concept does not seem to be achieved. X does not control the amount of the section 162 deductions. Similarly, if the fifteen per cent test is to be measured against the rental income to Y, why should X's interest expense be limited?

The second test is whether "the taxpayer is neither guaranteed a specific return nor is guaranteed in whole or in part against loss of income." These tests are in the conjunctive: that is, both have to be met. For some reason, the House Ways and Means Report treats these as alternative requirements. In any event, if Y agrees to pay X a fixed monthly rental, is this a "guarantee"? If it is not such a "guarantee", who must the guarantor be? If instead of a lease from X to Y, X had decided to enter into individual tenant leases, each one of the tenants, we would assume, would agree to pay their rent to Y, and isn't this a form of "guarantee" of rent? If X can keep his section 162 deductions to less than fifteen per cent of the rental income from these individual tenants who each are supposedly guaranteeing the income, X would seem to come under the net lease provisions.

There is a substantial question whether the definition of rental income in this subsection is intended to be exclusive. Should not a taxpayer have the right to invest in a rental property which is not a trade or business as to him but which would not qualify under the restrictive definitions of a net lease? For example, a retired taxpayer who invests in a four unit medical building may find, if he handles the leases himself, that the expenses of the building exceed fifteen per cent of the rental income, therefore, disqualifying him from the net lease category. Yet this type of activity would seem clearly not to constitute a trade or business, and therefore, should entitled him to treat the income as investment income which could be used to offset the interest expense on the building.

C. APPLICATION AT PARTNERSHIP LEVEL

The application of the limitations on deductibility of interest at the partnership level is inconsistent with the entire theory of partnership taxation which is firmly established in the Internal Revenue Code and Regulations under the Code. The partnership is a reporting entity only and not a taxpaying entity. Income and expenses of the partnership pass through the partnership to the individual partners.

The partnership has proven to be a flexible and effective method of investing in real estate. A limited partnership offers the limited partner the advantage of limited liability while taxing him as if he held the property directly. This method of capital pooling is attractive to many middle income taxpayers because by grouping a number of such people together in a limited partnership, all are able to participate in lucrative real estate investments which in the past have been available only to very wealthy individuals.

It is easy to demonstrate how this section would discriminate against the small investor in favor of the wealthy individual. Assume a large building is purchased for a million dollars and after a downpayment of $200,000, there are annual interest payments of $50,000 a year. Ten middle income taxpayers who could have purchased the property in a partnership would now find that instead of a

$50,000 interest expense available to the partnership, the expense could be limited to as low as $25,000, thereby resulting in the allocation of $2,500 of interest expense to each individual partner instead of $5,000. On the other hand, if two individual wealthy taxpayers were to purchase the property as tenants-in-common, they would each have a minimum allowable interest deduction of $25,000.

If section 221 is enacted in its present form, use of the partnership for investing in real property will be replaced by some form of common tenancy with the attendant liability risks and lack of flexibility. Rather than force the partnership out of existence, the desired result can be achieved by applying the interest limitation solely at the individual level.

D. THE CORPORATE EXEMPTION

We can see no reason why the limitation on allowable interest is applicable at the individual level but not at the corporate level. It seems to us that if the section is enacted many taxpayers will merely incorporate and contribute the income-producing and expense assets to the corporation. The assets contributed will be arranged so that there will be no taxable income in the corporation or perhaps loss. When the property is to be sold, the corporation will be liquidated in a section 337 liquidation and there will be a single capital gains tax at that time.

The House Ways and Means Committee Report gives as an example the following type of objectionable activity: "A taxpayer may borrow substantial amounts to purchase stocks which have growth potential but which return small dividends currently. Despite the fact that the receipt of the income from the investment may be postponed (and may be capital gains), the taxpayer will receive a current deduction for the interest expense even though it is substantially in excess of the income from the investment." (*Id.* at 72) It appears to us that a taxpayer could achieve substantially the same result merely by incorporating his investment assets.

E. INTEREST EXPENSES

Another area of confusion is the exclusion from the definition of "investment expenses" of section 165(c) (2) and (3) losses. The other forms of deductions which would be allowable to an individual all relate to his investment activities. Why aren't these type of losses allowable? Excluding these losses certanily benefits the taxpayer, since these losses do not have to be used to offset gross investment income, thereby maximizing the amount available to offset against investment expense, but what is the rationale for excluding them?

F. PREPAID INTEREST

Unlike the House Ways and Means Committee, we do not feel that the ruling issued on November 26, 1968, adequately deals with the problems of prepaid interest and we feel that our view is shared by many other people. A long line of cases and administrative rulings had upheld the principle that interest paid in advance by a cash-basis taxpayer is deductible in the year paid. The taxpayer was in difficulty only where there was no true indebtedness or where there was no "purposive" motive in incurring the indebtedness, other than securing the deduction itself. (See discussions by Miller, *Prepaid Interest*, 19 *U.S.C. Tax Inst.* 381 (1967) and Koster, *Prepaid Interest Purchase Method Still Useful Despite IRS Attack*, 30 *Journal of Taxation* 16 (1969).)

Prior to the IRS ruling, we felt any change in the law would require legislative action. Instead, the IRS, by its administrative action, attempted to reverse the existing case law. We believe that such action only compounds confusion and invites further litigation. Apparently the Treasury shares our concern. The March 24, 1969, Wall Street Journal contains the following:

> "Also with a view toward enhancing "equity", or equal treatment of taxpayers with about the same amount of income from various sources, officials say they're weighing whether to ask Congress to guard against a practice involving "bunching" of unusually large interest deductions. The Internal Revenue Service last fall ruled—contrary to Tax Court decisions—that investors paying in one year all the interest they owe over five years, for instance, couldn't deduct the whole amount in one year. To make "ab-

solutely sure" that such interest deductions are spread out over the life of the loan may require legislation, an official adds. Otherwise, he says, some persons might have a big enough deduction in one year to avoid paying any tax on income as large as $200,000." (at p. 2)

We know that the status of the deduction for prepaid interest is still very confusing to many taxpayers. We know that the Internal Revenue Service intends to challenge certain types of prepaid interest cases, but we are not satisfied that the position of the Internal Revenue Service is correct. Prepaid interest is an area of legitimate congressional concern and should have been dealt with as a part of any change in section 163 of the Code.

G. CONCLUSION

In summary, we feel that if Congress intends to change section 163 by limiting the interest deduction, it should do so in a manner that will minimize the problems that section 221 of the Bill would create. Such a change should include consideration of the deduction of prepaid interest. We respectfully urge that the Committee remove section 221 from the Tax Reform Bill to allow more time to consider the very complex problems and to draft a provision that will accomplish those purposes which the Congress feels are legitimately in the national interest.

II. Section 412

Section 412 would amend the installment sale provisions of section 453 to accomplish two things. The amendment would first require taxation in those corporate acquisition situations where assets are acquired through the use of debentures which are essentially the equivalent of cash, even though the debentures would not require principal payments for a period of years. The second part of the amendment is what concerns us. It would restructure the installment provisions to require the payment of periodic installments of principal in relatively even amounts. The exact procedure would be prescribed by the Commissioner in Regulations; however, there is a "safe haven" allowed if certain conditions are met. The safe haven test is met if payments of "relatively even" or "declining amounts" are made at least once every two years of the installment period or alternatively, if at least five per cent of the principal is required to be paid by the end of the first quarter of the installment period, fifteen per cent by the end of the second quarter, and forty per cent by the end of the third quarter.

We agree that if the equivalent of cash is received from the sale of an asset, the tax should be paid. If cash or its equivalent is not received, then Congress, in its wisdom, has said no payment of tax has to be made. Naturally, if the payment of principal is deferred, interest or imputed interest will accrue or be collected by the taxpayer which will be taxable at ordinary income rates.

This system has worked well for many years. The changes proposed will, however, drastically restructure and limit the flexibility that is now offered to taxpayers.

For instance, in California it is common practice for a landowner, often a farmer, to sell his land to a developer in a transaction where the developer will pay between ten and thirty per cent of the principal as a downpayment. The developer will then ask the owner to accept his installment obligation over a period of years. The owner will usually agree to wait for the balance of the purchase price to ease the developer's financial burden during the progress of his construction activities. In the meantime, the developer will be making periodic payments of interest.

This very typical transaction would no longer qualify as an installment sale if section 412, as proposed, is enacted. Even if the entire balance of the purchase price were agreed to be paid on January 2 of the year after the sale, the safe-haven test of the section would not be met and the entire tax would be due in the year of sale. If the balance of the principal were deferred for two years and thirty per cent of the principal had been paid as a downpayment, the landowner could easily qualify under the new section by requiring that an additional ten per cent of the principal be paid on January 2 of the next year, thereby meeting the forty per cent test. The balance of the purchase price could be deferred for as long as wished. It is hard for us to see why requiring this additional ten per cent payment is either a necessary or desirable policy of the tax law.

We are unable to understand the need for this part of section 412. Until the abuses sought to be corrected are identified, it seems to us folly to disturb tax provisions which have been in existence for fifty years. If there are abuses under the law in these types of sales—and we know of no such abuses—there must be a better way to solve the problem. We submit that setcion 412, as proposed, should be amended to remove all but the proposed addition of section 453(e)(4).

Respectfully submitted.

KINDEL & ANDERSON.

LOS ANGELES, CALIF., *August 20, 1969.*

COMMITTEE ON FINANCE,
U.S. Senate, New Senate Office Building, Washington, D.C.

GENTLEMEN: The "Tax Reform Act of 1969," H.R. 13270, is a praiseworthy attempt to promote equity in our tax system.

May I draw your attention, however, to two aspects of *Sec. 221* ("Limitation on Interest Deduction") of the Bill which, as written, are punitive and will have *hardship consequences potentially disastrous* for some taxpayers? It is my belief that these consequences were not fully anticipated in the drafting of the Bill. I refer to:

I. The *de facto retroactivity* of Sec. 221 to *non-liquid* commitments made in good faith under current tax laws;

II. The *discrimination* of Special Rule A (Sec. 221) against individual taxpayers who are members of *partnerships*, as compared to individual proprietors.

Beyond this I cannot disagree with the objectives of the Limitation on Interest Deduction, nor with specifics of the amount of limitation and the method of application. However, as one of many thousands of investors of moderate means, lacking the wherewithal to abuse the tax system, I would much rather see the limitation reduced than to have characteristics I and II, above, enacted.

POTENTIAL EFFECTS

In the following, illustrative references are made to the attached table which, for purposes of realism, represent contractually committed interest payments on trust deeds for the next several years for my membership positions in four limited partnerships which hold, as their sole investment assets, undeveloped land. The typical partner holds an interest of about two percent.

De Facto Retroactivity

The thousands of investors who hold land ownership among their investments, having made those purchases before H.R. 13270 was revealed, judged the merits of these holdings on the basis of current tax law. Unlike the situation of margin interest in security transactions, these interest payments are contractual commitments on trust deeds (mortgages secured by the land) and are *not liquid*. Default results in reversion of ownership and total loss. The potential losses under retroactivity are least controllable under partnership ownership, since various partners will interpret their economic interests in differing ways. If Sec. 221 is enacted as written:

Some members of partnerships (more probably those in high tax brackets) may decide that loss of significant interest deductions (e.g., $660 deduction vs. $10,400 paid out in 1970 in Partnership A, for a 2.64 percent holding) and loss of capital gains status for gains eventually offset by disallowed interest carryovers, recommend abandonment of their positions. This a limited partner could do without further liability but, presumably, with loss.

The remaining partners must replace those in default or assume the additional payment burden. Clearly, in view of the retroactivity of Sec. 221 and of Special Rule A, replacement of defaulting partners would be difficult, probably impossible. Since those remaining would tend to be of lower tax brackets and lesser means, such burden assumption could prove impossible. The result would be *serial abandonment* (in an effect much like a *bank run*) with *complete loss* of invested capital for all.

An alternative would be a distress sale of the full partnership property. This would be into a market weakened by the buyers' knowledge of the distress, by haste, by other partnership properties similarly situated, and by the depressive effect on potential commercial property of depreciation provisions of other sections of the Bill. Recovery of invested capital, or any part thereof, would be unlikely.

At the very best, should no abandonment occur (abandonment, for example, is somewhat less likely in Partnership B than in A because of the financial character of the partners and greater proportionate deductibility of interest), the investment made under existing rules becomes less valuable than when purchased simply through the loss of current deduction and of capital gains treatment on part of what is clearly a capital asset.

The many citizens who have elected to forego current consumption to accumulate and invest savings deserve better treatment at the hands of their government than this retroactive character wuold provide them. The IRS, for example, took care in 1968, in promulgating Revenue Ruling 68–643 on the subject of prepaid interest, to exempt future prepaid interest payments required by financial commitments undertaken before the date of the ruling. Incidentally, in this regard, large prepayments of interest, once considered to be a tax abuse in land purchases, are now controlled by R.R. 68–643. Ways and Means noted (House Report No. 91–413 (Part I, page 73) that no further action on prepaid interest is required.

Should total abandonment ensue, major losses by investors of moderate means would be sustained. (In my own case, if all four partnerships were involved, the losses would exceed $60,000, over half of my life's savings, even without possible additional losses in attempts to prevent collapse because of default of partners.) Some might argue that these transactions are on "shakey financial foundations;" if so, should tax law be used retroactively to topple them? In this regard, the average down payment exceeded 27 percent of the total principal amount, and the partnerships were formed under securities permits issued by the California Commissioner of Corporations, which is not a pro forma arrangement. I am sure my fellow partners did not consider investment in land in developing areas of California as unusually risky; but then that was before retroactivity of Sec. 221 and, in particular, of Special Rule A won House approval.

Discrimination Against Partners

The vast majority of investors in limited partnerships (of which I am aware) are of relatively modest means, as land investors go, and hold small fractions of the partnerships. (For example, in Partnership A, the minimum holding is 0.528 percent, the maximum 5.28 percent, representing down payments of $5,000 and $50,000, respectively. The average position is 1.7 percent. At the other extreme, in Partnership C, 38 of the 43 partners hold two percent each and the maximum holding is four percent. These represent down pyaments of $4,400 and $8,800, respectively.) Under current law, *These limited partners have no tax advantages* over single proprietors. If Special Rule A of Sec. 21 is enacted as written:

Most of these investors would be allowed to deduct only a trivial fraction of their interest payments (see examples of table) while single proprietors, who in thousands of cases have holdings no larger than my interests in Partnerships A and D, and in thousands more less than a tenth as large, would be able to deduct all interest payments up to the amounts of their personal limitations.

These partnership investors would see a much greater proportion of their gains (if any) offset by disallowed interest carryover than would single proprietors, rendering a vastly larger share of capital gains, on what is clearly a capital asset, subject to taxation (pre-taxation, at that) at regular income levels.

Because the partnership terminates once all property has been sold, if interest carryovers were to exceed net gains (if any), the remaining deduction would be lost to the partners irrevocably.

Under current law, all tax consequences (all gains, losses, property taxes and expenses) *flow through* to the partners in proportion to their ownership, with unchanged tax character, in the year of their occurrence. (The partnerships and partners usually are on the calender year, cash basis.) No tax benefits are derived from the partnership form that are not enjoyed by individual proprietors. Land investment partnerships are comprised of persons who lack the means and/or the knowledge and opportunity to select and purchase more promising land investments as single proprietors.

What possible objective of either *equity* or *reform* can be achieved by *depriving* partners of their right to current interest deductions of paid amounts *not exceeding* their personal limitation (defined by Sec. 221), as Special Rule A would do? (At the time of purchasing my position in Partnership D I rejected, as having marginally less investment merit, a single proprietorship land purchase requiring of me approximately the same down payment and carrying charges, including interest payments. Facing possible enactment of Special Rule A, retroactively applied, it seems I made a mistake, because interest payments in the single proprietorship would be fully deductible. Do taxpayers need crystal balls for anticipating retroactive changes in tax laws?)

To make tax treatment of individuals dependent upon the form in which they own property does not appeal to reason. Further, it is not the investor of moderate means who has been harvesting the tax laws. Even had he been, the $25,000 (plus offsets) limit on interest deduction, the limit on tax preferences, and the allocation of deductions would restrain his advantages sufficiently. Massive overkill is not required. Since the entire annual revenue gain from Sec. 221 is expected to be $20 million, the trivial part of that to be derived from Special Rule A scarcely can justify this distortion of taxpayer rights on revenue grounds.

SUGGESTIONS

May I strongly urge the Committee to consider the advisability of:

Elimination of the *de facto retroactivity* of Special Rule A, at least with regard to *non-liquid properties*, the financial commitments for which were made before August 6, 1969, because its enactment will induce *great financial hardship, perhaps disaster*, for many investors of moderate means, will not promote equity or reform, and will lead to trivial revenue gain.

Elimination of the future application of Special Rule A to *prevent partners from having the same rights as other individual taxpayers*, because it effectively will close a mode of investment to persons of moderate means, will not promote equity or reform, and will lead to trivial revenue gain.

Elimination of the *de facto retroactivity* of the remainder of Sec. 221 to *non-liquid properties*, because it will seriously affect financial commitments made in good faith under existing tax law, will not promote equity or reform, and will lead to trivial revenue gain.

Because of the costs and time involved I will not be able to testify. However, I respectfully request that this letter be made a part of the record of the Committee's deliberations on the Tax Reform Act of 1969. Thank you for your consideration.

Very truly yours,

PETER M. BELCHER.

CURRENT-YEAR INTEREST DEDUCTION PERMITTED UNDERSIGNED TAXPAYER IN 4 PARTNERSHIPS UNDER CURRENT LAW AND UNDER SPECIAL RULE A (SEC. 221) (TO NEAREST DOLLAR)

	1970	1971	1972	1973	1974	1975	1976	1977	1978
Partnership A (2.64 percent) (July 22, 1968):[1]									
Total interest	394,028	200,316	199,916	199,512	216,372	400			
Undersigned's interest	10,402	5,288	5,278	5,267	5,712	11			
Undersigned's deduction[2]	660	660	660	660	660	11			
Partnership B (2 percent) (Oct. 29, 1968):[1]									
Total interest				28,404	43,314	40,940	38,422	35,754	32,925
Undersigned's interest				568	866	819	768	715	659
Undersigned's deduction[2]				500	500	500	500	500	500
Partnership C (2 percent) (June 30, 1969):[1]									
Total interest		104,300	104,300	104,300	104,300	104,300	104,300	104,300	104,300
Undersigned's interest		2,086	2,086	2,086	2,086	2,086	2,086	2,086	2,086
Undersigned's deduction[2]		500	500	500	500	500	500	500	500
Partnership D (2.22 percent) (July 15, 1969):[1]									
Total interest	18,988	75,427	167,887	156,846	151,943	144,461	139,034	133,188	126,893
Undersigned's interest	422	1,674	3,727	3,482	3,373	3,207	3,087	2,957	2,817
Undersigned's deduction[2]	422	555	555	555	555	555	555	555	555
Total interest payment	10,824	9,048	11,091	11,403	12,037	6,123	5,941	5,758	5,562
Total deduction[2]	1,082	1,715	1,715	2,215	2,215	1,566	1,555	1,555	1,555

[1] Dates of deposit of full downpayments in trust accounts.
[2] Deduction under de facto retroactive application of special rule A of sec. 221 (H.R. 13270). Under current law, total deduction equals total interest payment.

Note: In no year do total interest payments reach 50 percent of the $25,000 permitted individuals under sec. 221. In no year do interest deductions permitted undersigned under special rule A (sec. 221) reach 10 percent of the $25,000 permitted individuals.

AUTONETICS,
NORTH AMERICAN ROCKWELL,
Anaheim, Calif., September 23, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: A number of provisions of the House passed "Tax Reform Act of 1969" are deeply disturbing to me. The one which disturbs me the most is the proposed application to Limited Partnerships of the limitation on investment interest. A worse aspect of this is that it would be applied retroactively to investments that already exist. I am one of a number of Limited Partners in an Orange County California Land Development Syndicate and the consequences of the proposed legislation to me and to the other Limited Partners would be most serious.

I urge that you do everything in your power to modify or eliminate this inequitable section of the proposed tax reform legislation. Although the Tax Reform Bill passed by the House of Representatives eliminate many tax abuses, there are several areas where unintended hardships were created. The interest provisions as contained in Section 221 stand out as creating the greatest possible inequities which could be solved by two simple amendments to the proposed changes:

1. By stating that in the case of a partnership, the provisions of the subsection shall apply only with respect to each partner (as opposed to also operating with respect to the partnership itself), and

2. By providing that "investment interest" shall not include interest paid or accrued on indebtedness incurred or continued to purchase or carry property which is acquired prior to some given date, which probably should be December 31, 1969.

Sincerely,

W. F. SAUERS.

APPENDIX D

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF NATURAL RESOURCES (HARD MINERALS)

Written testimony received by the committee expressing an interest in the subject of natural resources (Hard Minerals)

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C., September 29, 1969.

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

DEAR RUSSELL: I am forwarding herewith a letter I received from Mr. Homer Hooks dated September 24, 1969, regarding the proposed depletion allowance for certain minerals as contained in H.R. 13270, together with copies of his testimony that has been submitted to the Committee for consideration.

You may recall when H.R. 4069, to terminate certain tax provisions before the end of World War II, was being considered by the Senate on July 24, 1947, I introduced an amendment which was agreed to, to include phosphate rock in the 15% depletion allowance for various nonmetallic minerals. Having authored this amendment I would be extremely reluctant to see any action taken to reduce the allowance from 15% to 11%. However, since phosphate was only one of a large number of nonmetallic minerals included in the 1947 Act, (P.L. 80-384), it is realized that if the Committee, in its wisdom, reduces the depletion allowances, such reductions should be proportionate unless there are extenuating circumstances. It is here that I feel the testimony of Mr. Hooks defends very ably the need for retaining the present depletion rates on those minerals, including phosphate, related to the manufacture of fertilizer for the production of food for the United States and world population. In addition to phosphate it is recommended that other minerals such as sulfur, potash limestone and dolomite deserve special consideration for possible retention of the present depletion rates.

I call this to the attention of the Committee as I believe the suggestion of Mr. Hooks as contained in his testimony has considerable merit and I am hopeful that the Committee will carefully consider and act favorably on it.

With kindest personal regards, I remain

Yours faithfully,

SPESSARD L. HOLLAND.

STATEMENT OF THE FLORIDA PHOSPHATE COUNCIL, MAYWOOD W. CHESSON, PRESIDENT, SUBMITTED BY HOMER HOOKS

SUMMARY OF STATEMENT

1. In the original drafting of H.R. 13270, no consideration was apparently given to the impact of a decrease in percentage depletion on individual minerals. This kind of "across the board" treatment, without recognizing the characteristics and economic condition of each mineral, is patently unfair.

2. Phosphate and other minerals directly related to the manufacture of fertilizer for the production of food for U.S. and world populations (sulfur, potash, limestone and dolomite) deserve special consideration.

3. Phosphate reserves in the United States are smaller than those in competing countries, and the grade of deposits in the U.S. is generally lower than that of foreign reserves.

4. Foreign competition for worldwide phosphate markets is steadily increasing, in some cases aided and abetted by government-managed industries not necessarily susceptible to normal cost and supply-demand factors.

5. Proximity of foreign phosphate producers to foreign markets and resultant favorable freight rates puts U.S. producers in an even more severe competitive position.

6. Three successive bad-weather planting seasons in the United States and foreign competitive factors forced phosphate production declines in the U.S. in

1968 and has further driven the U.S. phosphate industry, especially in Florida, into a serious recession.

7. A decrease in the percentage depletion allowance would amount to an added cost for U.S. producers which would be a further detriment to our already precarious competitive position.

8. As the world faces a long-term population surge and an expected increase in demands for foods, fertilizers are playing an ever-growing role. A reduction in percentage depletion on the agricultural minerals named in number 2 above would seriously damage the current economic position of these minerals and inhibit their future development in the United States.

9. We therefore urge that H.R. 13270 be amended to restore the percentage depletion on phosphate, potash, limestone and dolomite to 15% and sulfur to 23%.

Mr. Chairman: As President of the Florida Phosphate Council, I am submitting to you for distirbution to your Committee the position of the Florida Phosphate Council on the provisions of H.R. 13270 that are of particular concern to the phosphate mining industry.

The Florida Phosphate Council, who members are listed below, is a non-profit trade association representing most of the firms mining and/or processing phosphate rock in the State of Florida.

Agrico Chemical Company;
American Cyanamid Company;
Borden, Inc.—Chemical Division/Smith-Douglass;
CF Chemicals, Inc.;
Central Farmers Fertilizer Company/Central Phosphates, Inc.;
Farmland Industries, Inc.;
W. R. Grace & Co., Agricultural Chemicals Group;
International Minerals & Chemical Corporation;
Mobil Chemical Company;
Occidental Chemical Company;
Royster Company;
Swift Agricultural Chemicals Corp.; and
USS Agri-Chemicals.

The Council is grateful for this opportunity to express its views on tax reform, a subject of increasing concern on the part of American business due to the heavy tax burden and the impact on the economy. We believe the entire nation shares this concern. It is our hope that these hearings will aid in developing a program of tax reform consistent with the economic needs of our nation, with the least detrimental effect on taxpayers and on economic growth.

The Florida Phosphate Council believes that attainment and maintenance of a sound domestic mining industry requires recognition in the tax laws that certain minerals used in the manufacture of fertilizers, such as phosphate, hold a unique position in the nation's and the world's welfare and economy and deserve a degree of consideration that, unfortunately, was apparently not given in the "across the board" reductions in percentage depletion as proposed in this bill. Other minerals in this agriculture category include potash, sulfur, limestone, and dolomite.

We submit that tax reform should take into account the characteristics of each extractive industry and cannot be adequately or equitably accomplished without close study of each mineral industry. They are not all alike, and sweeping, class treatment of them is patently unfair.

We can find no evidence that the singular merits of each segment of the mining industry were recognized or considered prior to the introduction of H.R. 13270. Instead, a general form of legislation has been proposed that is all-encompassing, placing all types of natural resources into large groups, ignoring the differences and uniqueness of each.

Therefore, we feel it is incumbent on this Congress to fully examine and determine all the facts relating to each different type of mining. Only then can a fair and equitable finding be made and proper reform accomplished.

I will now direct my remarks specially to the phosphate industry and our strong and justifiable opposition to the proposed reduction in the depletion rate from 15% to 11%—a 26.6% differential.

Phosphate rock is unique in that it is the basic source of the element phosphorus, which is essential in the makeup of every living cell, tissue and organism. Humans must have phosphorus for survival—they obtain it from the food consumed in their daily diets. There is no substitute—natural or synthetic.

Phosphate is indispensable in the manufacture of fertilizers and plant foods used to feed the hungry people of the world—both here and abroad, notably in the underdeveloped nations.

There are four major phosphate producing regions in the United States. Florida is the largest producer, followed by a quadrangle of states in the West: Idaho, Montana, Utah and Wyoming. North Carolina is a new producer, but growing in importance. Tennessee is the fourth ranked phosphate mining area of this country.

Production in these areas accounts for approximately 46% of the total world output of phosphate. In 1968 U.S. production amounted to an estimated 40 million tons.

It must be considered, however, that despite this high percentage of world production, the economically recoverable reserves in the United States as a percentage of estimated world phosphate reserves is considerably lower—less than 30% of the world total. This factor becomes even more critical when one considers that much of the higher grade phosphate rock in this country—especially in Florida—is being exhausted. This means that in the future, exploration, extraction and processing of lower grade ores will substantially increase mining costs in the U S.

On the other hand, much of the phosphate in Morocco, the Spanish Sahara and other areas of the world is of higher grade than that found here and the reserves are much larger.

Also consider the fact that much of the United States competition for international phosphate markets is either government owned, dominated or supported. Such is the case in Soviet Russia—second largest producer in the world—and Morocco, third ranking producer and the world's largest exporter of phosphate rock. This means that prices from these competitive sources may not reflect cost structures nor a supply/demand circumstance.

The depletion allowance is one of the primary reasons United States phosphate producers have been able to maintain a fair share of world markets in the face of this adversity.

Still another factor in favor of foreign producers is the decided delivery cost advantage which invariably enters into the overall cost of a high volume, bulk commodity such as phosphate.

Since more than one third of this nation's total phosphate production is shipped to foreign countries, this factor is extremely important. In reality, the cost of shipping a ton of phosphate often is more than the price of the rock itself, which points up the critical competition involved in selling to customers in Western Europe and Great Britain. Morocco is closer to these markets than we are and can deliver cheaper.

For example: The ocean freight rate from Tampa, Florida, to Rotterdam on phosphate is $5.00 to $5.25 per long ton, but the rate from Casablanca. Morocco, to Rotterdam is about $3.25 per long ton. Morocco can ship to Italy in small vessels for about $3.00 per long ton, as compared to our rate of $5.00 to the same ports in Italy. The rate from Casablanca to Spain or Greece in small vessels is about $3.00 to $4.00 per ton, comparable to a rate from Tampa of $8.00 to $9.00 in the same size vesels.

These factors alone justify the continuation of the present 15% depletion allowance on phosphate. Any weakening of our world-wide marketing ability would lead straight to economic recession. It is not an understatement to affirm that any reduction in the phosphate industry's depletion allowance would place this industry in a most hazardous competitive position in the world markets.

There are, moreover, other unique features about the phosphate industry which deserve your attention and consideration before a decision on the depletion allowance on this mineral is reached.

At this very moment, the United States phosphate industry is in the throes of a most difficult period. In addition to the rigorous foreign competition already described, domestic production 1968 fell below previous years and indications are that 1969 will be even worse.

The reason for this unfortunate condition is one that neither government nor business can quickly remedy. Unprecedented weather conditions that have prevailed over the major farming and fertilizer consuming areas of the United States for the past three years have drastically curtailed sales and pushed inventories to new highs. For the first time in over 20 years, the 1969 planting season showed a drop in the demand for domestic plant nutrients.

As a result, prices have been slashed, revenues have diminished further, and dwindling financial return to fertilizer manufacturers is sinking even lower.

Adding to our problems is the fact that a tremendous expansion program was initiated a few years ago, largely on the basis of projected purchases for the AID program of our government. Gearing production to meet these anticipated needs, our firms made long-range commitments that were non-retractable when AID funds were drastically reduced.

This combination of developments has resulted in employment cutbacks in the Florida phosphate fields from a high in January 1967 of 10,400 workers to an estimated 9,000 today. Industry payrolls which reached a record high of $71.7 million in 1966 have sagged to $68 million in 1968, despite incremental wage increases. Total earnings this year are expected to drop still lower.

I can tell you gentlemen quite frankly that nobody is making money in the phosphate business today. The industry is sick.

I submit to this committee that the proposal for reducing the depletion allowance on phosphate could not have come at a more unfortunate time. And I cannot overstate the results which such action would bring about.

It comes at a time when those companies which deal primarily in fertilizer materials are struggling to survive.

H.R. 13270, as it passed the House, would reduce the phosphate depletion rate from 15% to 11%—or a reduction of 26.6%. This reduction would amount to approximately 13¢ for every ton of phosphate rock mined. Now, what would this added cost of 13¢ a ton do to us?

In the domestic market, the producer would be required to absorb this additional cost on top of a dwindling profit margin—or to increase prices. The latter is just not possible in today's market picture. The former might well put some of us out of business.

If the U.S. producer adds 13¢ to foreign sale prices—which already hang in balance on the basis of pennies a ton—it is safe to assume that a majority of this nation's phosphate rock exports would be lost to foreign competition.

Should this occur, this nation would immediately lose millions annually in balance of payments, phosphate miners in this country would have no place for their production, and the eventual result would be a depression on an already burdened phosphate mining industry.

To this point my remarks have dealt primarily with factors which are germane only to the phosphate mining industry and may not apply to other extractive industries.

There are other types of mining which do have many things in common, such as land reclamation requirements after mining is completed, air and water pollution control installations to protect the environment, and the very substantial tax load which we are already bearing. The extractive industries are active in all these areas.

With respect to taxes, in most of the communities where we operate in Florida, the phosphate industry is literally the backbone of the tax structure. Our companies paid more than $6.5 million in property taxes in 1968. In Polk County, Florida, center of operations, phosphate tax payments accounted for more than 20% of the total county ad valorem tax roll in 1968. The phosphate industry also is subject to the same type of sales and use taxes as other industries.

Finally, let me summarize briefly the justification for continuing the depletion allowance on phosphate at 15% and the other agriculture minerals at their present rates.

It has been recognized that minerals in the ground have no usefulness to the people until someone has the courage and persistence to expend substantial amounts of risk capital in searching for, finding, acquiring, developing and making them available to consumers.

Most of the advanced countries in the world today recognize that their minerals and natural resources form the basic foundation for economic strength and growth, and have provided necessary encouragement in one form or another for their production.

The practical effect of percentage depletion is greater production of minerals at a lower price, and an inducement for increased use of the nation's natural resourecs.

Without recognition in the tax laws of the capital value being depleted by production, taxes would be devouring the capital of mineral producers and depriving them of the funds needed to replace reserves in order to remain in business and continue to supply essential minerals.

The extraordinary risks involved in searching for and producing minerals, the long time lag between investment and production, and the possibility of a total loss of the investment in unsuccessful ventures, with no possibility of converting to another type of business, are among the factors that make percentage depletion necessary. With the demand for natural resources to meet the requirements of our advancing civilization, and the ever-increasing risks and cost in replacing depleted reserves, it is more essential than ever that we maintain the present tax treatment of natural resources in order to assure the nation's economic growth.

Percentage depletion aids in keeping the mining industry competitive with foreign mineral producers and provides funds for use in mineral research and recovery methods, resulting in mineral conesrvation; it provides funds for exploration of continuing mineral deposits and the development of mines; it provides the funds for the construction of plants designed to give a better and fuller use of the nation's natural resources.

With respect to the phosphate industry specifically, allow me to summarize:

—The phosphate industry is unique in its makeup. Little or no attention was given to the specifics of this industry or to the other agricultural minerals or to the total impact of a reduction in percentage depletion on these minerals before the introduction of H.R. 13270.

—Phosphate rock is an indispensable ingredient in the manufacture of fertilizer for which there is no substitute, natural or synthetic. It is truly a mineral of life, essential in the diets of all mankind.

—United States economically recoverable phosphate reserves are smaller than those of foreign producers, and the grade of domestic deposits is generally lower than that of foreign competition.

—A reduction in the depletion allowance for phosphate would severely damage United States producers from exporting to international markets.

—The phosphate industry in this country is in the midst of a depressed period, and a reduction of the depletion allowance would drive marginal producers to the brink of disaster.

—The basic premise of the depletion allowance as originally constituted makes it mandatory that this policy be continued in order to assure orderly development of natural resources, continued growth, and, hopefully, prosperity.

Taking all of the above into consideration, it would seem to me most appropriate that the agricultural minerals—such as phosphate, potash, sulfur, limestone, and dolomite—be continued at the same percentage depletion allowance as now exists, sulfur at 23% and 15% for the others, so that these vital ingredients in chemical fertilizers can continue to survive and play their part in providing the necessary plant foods, so that farm crops, both at home and abroad, might produce the bountiful foods to feed the ever-growing population of the world. With the specter of a doubled world population by the year 2000, this is certainly not the time to impede in any way the reasonable growth of these vital mineral industries, and so I ask this Committee to consider most seriously the restoration of these minerals I have named to their present percentage depletion rates, for humanitarian as well as economic reasons.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., October 1, 1969.

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

DEAR MR. CHAIRMAN: This is with reference to the percentage depletion allowance for certain metals which your Committee is presently considering as part of the Tax Reform bill recently passed by the House of Representatives (H.R. 13270).

Section 501 of H.R. 13270 generally reduces the percentage depletion allowance for oil and gas and most minerals. However, regarding gold, silver, copper and iron ore, section 501(b)(3) keeps the percentage depletion allowance at the same 15% rate which exists under the present law, but only for mines or deposits located within the United States. If the mines are outside the United States the allowance is reduced to 11%. This creates an unfair treatment for mines in Puerto Rico because the only definition of "United States" in the Code defines the term as "the States and the District of Columbia" (section 7701, Internal Revenue Code). In other words, under the language of H.R. 13270 as passed by the House, mining operations in Puerto Rico are considered as "foreign."

This is not only contrary to reality but contrary to the previous part of section 501 of the House bill which deals with depletion allowance for oil and gas. That other part of the bill (section 501(b)(1)) treats oil and gas wells located in Puerto Rico in the same manner as oil and gas wells located in any of the fifty States. It eliminates the percentage depletion allowance for foreign oil and gas wells but gives such wells, if located in Puerto Rico, the same 20% allowance they would have if they were located in any of the States. And yet, there are no known oil or gas deposits in Puerto Rico.

We are sure that the reason why Puerto Rico is being treated as "foreign" for purpose of mineral depletion while being treated as domestic for purpose of oil and gas depletion is that the Ways and Means Committee was not informed that there are copper deposits in Puerto Rico. The fact is that, at the present time those deposits are not being mined but negotiations are being carried on to allow certain American firms to mine them. The deposits are not of a high-grade mineral content and the additional 4% depletion allowance is highly important in determining whether the mining operations will be economically feasible.

Furthermore, the report of the Ways and Means Committee indicates that the reason for not cutting the depletion allowance for domestic mines is to encourage exploration and the discovery of new domestic reserves. At a time when the government of Chile has taken steps to nationalize 51% of the U.S. copper mines in that country and when the African Republic of Zambia is also reported ready to do the same, it becomes essential to keep the 15% rate for the mines located in Puerto Rico which will never run the risk of being nationalized and which will assure a supply of part of the copper needs of the country.

In conversations with your Committee's Chief Counsel, Mr. Vail, it was noted that our objective can be accomplished in either of two ways: first, by leaving present law as it is, and second, by amending section 501(b)(3) to read "15 percent—if the mines or deposits are located in the United States or the Commonwealth of Puerto Rico . . ." Both solutions are acceptable to Puerto Rico and we leave that decision to your Committee.

I trust that your Committee will give favorable consideration to this matter and I thank you indeed for your valuable cooperation.

Sincerely,

JORGE L. CÓRDOVA.

TEXAS GYPSUM,
Irving, Tex., September 24, 1969.

Hon. R. B. LONG,
U.S. Senate,
Washington, D.C.

DEAR SIR: We urgently request that at the Senate Finance Hearings, of which you are Chairman, you use your influence to retain the present 15% depletion allowance for gypsum.

The ultimate effect of a reduction of the depletion allowance on this segment of the building industry can only be an increase in building costs, and a further penalty to an industry which has been severely depressed for some time now because of increased labor and material costs, high interest rates, and the resultant low residential housing starts.

Unlike many other segments of the building industry, the prices for which we sell our product have steadily declined over a period of years until they are now at an all time low. As with any increase in taxation, a reduction in the percentage depletion allowance will be more severely felt by small, independent producers, such as ourselves, than by the larger multi-plant producers; so the long-term effect of such action is a tendency toward a reduction in competition.

As a Senator from the State of Louisiana, you are aware that there are several gypsum companies, with several hundred employees, operating in the State of Louisiana at the present time. Any reduction in depletion allowance of gypsum at this time can only result in higher cost of operation and less profits, and as a long-term effect will result in less venture capital and consequent failures to develop gypsum reserves in your state.

For these and other reasons, we urgently solicit your support for the retention of the present 15% depletion allowance on gypsum.

Very truly yours,

TED E. ARMSTRONG, Jr.,
Executive Vice President.

STATEMENT OF CHARLES E. BRADY, PRESIDENT, MATERIAL SALES CO., SALISBURY, N.C.

I am Charles E. Brady, President of Material Sales Company, Salisbury, North Carolina. Material Sales Company is sales representative for quartzite produced by Lessees of B. V. Hedrick Gravel and Sand Company and W. R. Bonsal Company of Lilesville, North Carolina; and for Becker Sand and Gravel Company of Cheraw, South Carolina.

Quartzite is the mined raw material from which the metal silicon and its many alloys are produced. The metal silicon is not found as such in nature. Quartzite is reduced in an electric furnace along with an oxidizing agent to produce the pure metal silicon. Some of the companies producing this metal are: Electrometallurgical Division of Union Carbide Corporation, Electrometallurgical Division of Air Reduction Corporation, Interlake Steel Corporation. Foote Mineral Corporation, Ohio Ferro-Alloys Corporation, Tennessee Metallurgical Company, and others.

The metal silicon is not unlike aluminum in appearance. It is very hard, has great tensile strength, is light, and highly heat resistant. Because of these qualities it is used in alloys of iron (Ferro-Silicons), alloys of steel and maganese, alloys of steel and chrome, and it is essential in the making of aluminum used in automobiles, trucks, airplanes, and in the hundreds of other aluminum products. Silicon is extremely important in times of peace, and its use and importance multiplies in times of national emergencies.

The purity of the quartzite (SiO_2 content) is essential in making the grade of silicon needed to make the high quality alloys needed in modern metallurgy. Consequently the prime source of this quartzite is from Marlboro County, North Carolina, and from Harnett and Anson Counties in North Carolina. The quartzite produced from these sources by the aforementioned companies, whom we represent, analyzes 99.5% SiO_2 and better.

In 1951 the congress recognized the importance of quartzite to the metallurgical industry granting it 15% depletion along with gold, silver, iron and copper ore, and oil shale. None of these are proposed to be reduced, but H.R. 13270 proposes to reduce quartzite to 11%. I urge that you recognize the need of allowing quartzite to remain in the 15% depletion category. The known reserves of quartzite in Anson and Harnett Counties in North Carolina, and Marlboro County in South Carolina, are estimated at the present rate of consumption to have a life of from only 15 to 20 years. Each of the production companies we represent keep a trained crew of men and geologists prospecting for and testing for additional quartzite deposits. Within the past three years they have purchased more than 1,500 acres of land at a cost in excess of $1,250,000.00 and have invested more than 2½ million dollars in new plants and facilities.

Even though the total production of metallurgical quartzite is small when the whole United States is considered, the approximately ½ million tons, mined and shipped from North Carolina and South Carolina, constitute an industry of importance to these states, and supplies a mined product of vast importance to almost every heavy industry in our country.

There is considerable evidence that the producers of quartzite need this allowance to help them finance the exploration costs, and the acquisition costs of additional high quality quartzite, and should the supply of this high quality quartzite become scarce, or require more expense in the acquiring, then the cost of quartzite to the electro-metallurgical industry would be greater, their profits consequently smaller, resulting in tax losses which we think would more than offset any revenue resulting from the cutting of quartzite's depletion allowance.

The new areas where quartzite is known to exist in quality and quantity sufficient to justify commercial production, and that are reasonably accessible physically and economically, are so scarce as to appear non-existent at this moment. I urge you to encourage this industry, small in size, but of key importance to our economy.

Thank you.

STATEMENT OF ILLINOIS ASSOCIATION OF AGGREGATE PRODUCERS

The proposed reduction in the depletion allowances on wasting assets in the mining industry, in our case, sand, gravel and stone, will produce results quite adverse to anything planned or imagined by this measure.

If this Bill is designed to increase governmental income, curb inflation,, eliminate "windfall profits" and similar claims, as reported by the press, the sponsors will find that the results of this piece of legislation will be to the converse of all the claims.

The aggregate industry is the fundamental industry of our economy. Without it, nothing is built. Without it, everything deteriorates—transportation, power, communications, etc. I can not think of any thing in our lives that is not related to, or dependent on, the basic ingredient of construction—aggregates.

This cornerstone industry of our economy is founded on the extraction of a wasting asset. The 1% reduction, from an allowance of 5% to 4%, is a 20% cut. The allowance for our industry, if anything, should be raised 100% or 200%. The highly definitive laws of science do not apply to the prospecting for a suitable piece of property for aggregate production. Mother Nature was very whimsical when she laid down deposits of sand, gravel and stone. Even though the most highly sophisticated methods available for prospecting for these minerals are employed, final judgment on a site, because of the high degree of variability, is based on a program of repetitive testing, drilling and excavation. Even then, success is not assured. Changing deposits, changing demands and specifications and changing markets make our industry one of high risks. If a man builds and tools up to manufacture a product and fails in that business, he has a residue in his capital expenditures and an opportunity to put his plant to another use. Our industry does not enjoy that opportunity.

Specifically, in the State of Illinois, and I'm sure most states are in a similar situation, we find ourselves just entering into a massive highway building and upgrading program. This project will surpass any highway project in the history of the State. It will give Illinois one of the finest high-speed, intrastate highway networks in the Nation. In order to provide this facility for the taxpayers at the lowest possible cost, numerous pits and quarries will have to opened throughout the State, particularly, in the more remote areas where there are no existing plants today. These new operations will supply quality materials at an acceptable cartage rate. Without these new operations, material will have to be hauled great distances in some cases. A cut in the meager allowance allotted to our industry will make it just that much more difficult to justify opening a new operation. What we need is a greater incentive to prospect and open new deposits, not a lesser one. A decrease in the already inadequate depletion allowance for our industry will simply mean an additional expense to be passed on to the customer. Another step in the march of creeping inflation. Another inadequacy in our regulatory system.

AMERICAN MONUMENT ASSOCIATION, INC.,
Olean, N.Y., September 29, 1969.

Senator RUSSELL B. LONG,
502 Union Federal Building,
Baton Rouge, La.

DEAR SENATOR: As a representative of all of the quarriers of granite and marble in the United States, I ask your consideration in the retention of the 15% depletion allowance now granted to our product.

It is my understanding that the tax reform bill now under study by your Committee has been proposed because there is a general feeling that those at the top of the income scale are getting too much advantage from it. The remedy proposed is to tighten the screws at the top and loosen them at the bottom. I feel that this industry is a definite part of the bottom.

The gross annual sales from the quarrying of granite and marble would fall short of forty million dollars and our largest quarrier would realize gross sales of approximately three million dollars. In terms of reference, generally used in our economy today, this places us at the lower end of the economic scale and even in terms of definition used by the Federal Government qualifies us as "small business".

Because our product is quarried and manufactured in mountainous sections of the country, these are usually economically disadvantaged areas also, and many small communities are entirely dependent upon our product for their industrial prosperity. As an example, Barre and Proctor, Vermont; Elberton and Tate, Georgia; Rion, South Carolina; Milbank, South Dakota; Snyder, Oklahoma; and Marble Falls, Texas, are entirely dependent upon our industry, while our quarrying operations make an important contribution to large communities in twenty-two states of the Union.

Because of the static nature of our market "cemetery monuments" and a highly competitive situation, the net profit for most of our companies after taxes is approximately three per cent.

I sincerely believe that any reduction in the present depletion allowance would cause the quarriers to increase their prices which would then be passed on through the manufacturers to the ultimate consumer, and would defeat the entire anti-inflationary objectives of the proposed legislation.

The one hundred and thirty two members of this association would sincerely appreciate your assistance in helping to maintain the present depletion law, as it pertains to granite and marble.

Sincerely,

F. E. FOSTER,
Executive Vice-President.

STATEMENT OF THE NATIONAL ASSOCIATION OF MARBLE PRODUCERS AND THE MARBLE INSTITUTE OF AMERICA, SUBSTITUTED BY DON A. HAGERICH, EXECUTIVE DIRECTOR, MARBLE INSTITUTE OF AMERICA

The National Association of Marble Producers is an association of American marble producers (quarriers) of approximately 95 percent of the natural quarried domestic marble and travertine production.

The Marble Institute of America is the American marble industry's national trade association of companies engaged in producing (including almost all the members of the National Association of Marble Producers), importing, wholesaling, manufacturing and contracting for approximately 85 percent of domestic marble sales.

Marble production in the United States is a declining industry at a time when production of most other non-precious minerals is growing at a pace comparable to that of the growth of the Gross National Product. This decline is due partly to unlimited importation of foreign fabricated marble and partly to the increased use of simulated marble and other manufactured competitive materials.

Unlike the gigantic oil and gas industry, the marble producing industry enjoys no protection from foreign competition. There is no quota for imported fabricated marble, such as the oil and gas industry has, and which enables that industry to keep prices artificially high. The tariff on imported fabricated marble was only 21 percent ad val and lowered further by the GATT agreement at 10 percent per year to 10.5 percent by December 30, 1973. This rate is so low that it plays no effective part in protecting the marble producing industry in the United States from foreign imports.

For example, Italian marble can be quarried, fabricated, and shipped to the United States for about 40 percent of the cost of U.S. produced marble of a comparable quality shipped to the same building site.

The total United States sales of marble in 1966 increased to 48 percent above 1956, while the sales of domestically fabricated marble decreased 2 percent. During the same period, the United States sales of imported fabricated marble increased by 534 percent. This staggering gain in sales of imported fabricated marble was made possible by the 40 percent cost differential and the lowering of tariffs.

The presently authorized depletion rate for marble is 15 percent. In 1968, this amounted to approximately $1,900,000. The Tax Reform Act of 1969, as passed by the House, would cut this rate to 11 percent, a reduction of more than 26 percent, about the same as that of the multi-billion-dollar quota-protected oil and gas industry.

The additional tax revenue from marble production represented by the proposed change would amount only to approximately $530,000, assuming continuation of production at the 1968 rate, a doubtful assumption. Contrasted with this drop-in-the-bucket benefit to the Treasury, the amount represents a crucial decrease in the after-tax revenue of the domestic marble producers. There is a desperate need on the part of the American marble industry to find new deposits of sound quality marble more easily quarried, to devise and perfect new means of more efficient quarrying of known deposits in order to cope to some extent with unchecked foreign competition. Such exploration, research and development is costly, but promise to keep alive an old, honored and specialized industry, which makes an aesthetic and quality contribution to building construction at a time when the need for such a contribution is evident to every eye.

The National Association of Marble Producers and the Marble Institute of America oppose the proposed reduction in the existing 15 percent depletion rate for marble. The action of the Ways and Means Committee was not based on study of the marble industry, or of the mining industry generally. The action appears rather to have been based on conclusions reached from examination of the special circumstances of the oil and gas industry, rich in itself and highly favored by tax laws even with reduction in the depletion allowance.

The effect of the Ways and Means Committee action would be to make the poor poorer. It is submitted that if the policy reflected by the Tax Reform Act of 1969, indeed is the tentative policy of the Congress, the proposed change should be the subject of a thorough-going study of its effect, rather than by a decision reached without consideration of the effect on the subject industry.

Statement of Ian MacGregor, Chairman and Chief Executive Officer, American Metal Climax, Inc.

MOLYBDENUM PERCENTAGE DEPLETION

American Metal Climax, Inc. is a diversified mining and metal processing firm. Our Climax mine at Climax, Colorado is one of the major producers of molybdenum and is the Free World's single most important source of that metal.

Molybdenum is a vitally important metal which is chiefly used by the steel industry as an alloying element. Over 80% of molybdenum produced is used in this alloying with iron and steel in making tool steels, stainless steels, and a wide range of constructional alloy steels, as well as special steels for corrosion resistance and elevated temperature service. Molybdenum also has smaller but growing use in such "space age" applications as rocket motors and electronics. Molybdenum was classified as a strategic mineral under the Korean excess profits tax and it has been stockpiled as a strategic and critical material by the U.S. Government.

At the present time molybdenum is entitled to only a 15% percentage depletion allowance, whereas all the other important ferro alloys used in making alloy steel are entitled to 23%. These other alloys are chromite, columbium, manganese, nickel, tungsten and vanadium. This appears to be an unreasonable discrimination against molybdenum. In fairness, molybdenum should be included in the 23% category. Equity would seem to require that it should be treated no differently than other ferro alloy materials and, therefore, it would be appropriate at this time to transfer molybdenum to Section 613(b)(2)(B) of the Internal Revenue Code.

The House-passed tax bill H.R. 13270 would reduce the 23% category to 17% and the 15% rate to 11%—except for copper, gold, silver, iron ore, and oil shale which will remain at 15% if domestically mined. If it should be decided that molybdenum should not be transferred to the 23% category (proposed to be reduced to 17%), at the very least molybdenum should be added to the exception group in the present 15% category. Otherwise, molybdenum will be the only important industrial metal reduced to as low a rate as 11%, a situation which would compound the present discrimination.

During the period 1963–1966 molybdenum was in critical short supply. Usage for the metal is growing at an extremely fast rate and unless major new mines are developed it is anticipated that it will again be in short supply in the not too distant future. An adequate rate of percentage depletion is an important factor in providing the incentive to risk the substantial sums required to explore for and develop these mines.

My company has been engaged for the past four years in developing a new source of molybdenum at its Henderson mine in Empire, Colorado. We estimate that the cost of bringing this new mine into production (in the mid-1970's) will exceed $200,000,000. Needless to say, the percentage depletion deduction for molybdenum is an important element in our decision to go ahead and will be of great significance in financing the project.

In conclusion, we believe Section 613(b)(2)(B) of the Internal Revenue Code should be amended by adding after the word "mercury" appearing therein the word "molybdenum".

IAN MACGREGOR.

NTAIONAL COAL POLICY CONFERENCE, INC.,
Washington, D.C., October 3, 1969.

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

DEAR MR. CHAIRMAN: This is letter is to inform you that National Coal Policy Conference, Inc., desires to be on record as fully endorsing the testimony on the Tax Reform Act of 1969 presented by Mr. Brice O'Brien, General Counsel of the National Coal Association, *before your Committee on September 30.* We did not request an opportunity to testify because it seemed unnecessary to duplicate Mr. O'Brien's excellent presentation of the situation, but would appreciate this statement of support being included in the formal record of your hearings. For the record, it should be noted that the National Coal Policy Conference, Inc., represents American bituminous coal producers, the United Mine Workers of America, the principal coal-hauling railroads and barge lines, leading electrical utility systems utilizing coal for fuel and the principal manufacturers of coal-mining machinery and equipment.

Anyone familiar with the coal industry and cognizant of our tremendously increasing national power needs must recognize that it is imperative that proper incentives to attract investment capital for new mines and production facilities, as well as building and acquisition of transportation equipment, is absolutely necessary in the national interest.

The nation is in a dangerous position today because the East Coast has become precariously dependent upon imported residual fuel oil for much of its power generation, as well for industrial and commercial purposes. If an emergency situation should suddenly halt the influx of this oil, the coal industry would be in no position to make up any substantial part of the lost energy fuels because, for the past several years, the government has ardently promoted atomic energy along with a major public relations and propaganda campaign aimed at convincing both the public and the investment sector that nuclear plants were the whole answer to our fuel needs for the future. At the same time, Federal policy was continuing to permit increases in the importation of foreign heavy fuel oil and in 1966 completely eliminated quota restrictions on its import. As a result, there was no incentive to finance and construct mining facilities aimed at serving the East Coast market.

In addition. other government policies, while we do not quarrel with their objectives, are making it more expensive to produce coal and, thus, adding to the problems of financing new installations and market competition. We believe it would be most unwise to further erode incentives for growth of the coal industry and fully endorse Mr. O'Brien's suggestion that rather than reducing the 10% depletion in the existing law, coal should be at least given the 15% depletion rate now applicable to all other minerals. We further urge that the limit on taxable income from the property should be liberalized for the marginal or near marginal producers.

With electric power demand increasing at an even more rapid rate than the "doubling every ten years" which had been projected for it a year or two ago, and with the delays and unanswerable problems plaguing the large nuclear power generators, it is clear that a major increase in coal production for electric generation will be necessary for a number of years to come. We sincerely urge the Congress not to take steps affecting the taxation of coal producers which would further hamper our ability to meet these national energy demands.

Sincerely,

W. W. McCLANAHAN, Jr.,
Vice President.

CLOW CORP., *September 22, 1969.*

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

DEAR SENATOR LONG: As a manufacturer of clay pipe, I am writing you to urge your appropriate action to maintain the 7½% depletion allowance now proposed to be reduced to 5% in the Tax Reform Bill. This reduction in depletion allowance will obviously increase our cost of manufacturing and place us in an increasingly unfavorable competitive position with other sewer pipe manufacturers, and primarily that of concrete which enjoys a 15% depletion allowance on their basic ingredients—limestone and shale—which is to be reduced to 11½%.

Recent history of clay depletion allowances makes the present proposed reduction inequitable. Prior to 1960, the fire clay necessary in sewer pipe manufacture to produce a Federal Specification product enjoyed a 15% allowance which, without warning, in 1960 was reduced to 5% a reduction of 66.6%. In response to a plea for equity, Congress in 1966 agreed to a partial restitution by raising the allowance to its present status of 7½%.

While all other minerals are to be reduced on a proportionate basis from their original allowance, clay is to be subjected to the same proportionate reduction from a base already 50% lower than its original percentage allowance. Surely this is inequitable by any objective standard.

In such matters as eliminating the 7% investment tax credit, which is applied uniformly to all business and industry, I make no objection. I do, however, object strongly that the treatment accorded clay pipe manufacturers will not be equitable and fair if the provisions of the present bill are allowed to pass into law.

Please do whatever you can to insist on equitable treatment of all industries and not permit the perpetuation of an unfair penalty for our industry.

Sincerely yours,

R. G. RINEHART, *President.*

THE ROBINSON CLAY PRODUCT COMPANY,
AKRON, OHIO, *September 19, 1969.*

Hon. RUSSELL B. LONG,
Senate Finance Committee,
Senate Office Building,
Washington, D.C.

MY DEAR SENATOR LONG: As the Senate prepares to consider the complex and vital subject of Tax Reform, I thought it might be helpful to forward my view on one aspect of this matter.

As the President of The Robinson Clay Product Company, and Chairman of the Clay Pipe Industry Depletion Committee, I hope that there will be no reduction in the relatively minor 7½% depletion allowance. In making this request, I am not unmindful of the desire of many members of Congress to introduce changes in the tax code in the interest of equitable treatment. This same emotion caused me to refrain from any objection when the House recently voted to repeal the 7% investment tax credit, at considerable potential cost to my company. That action at least had the virtue of affecting all business like. A reduction of the clay depletion allowance would further weaken clay pipe manufacturers in our severe competition with the many other pipe materials.

A review of the brief statement attached hereto reveals how the clay pipe depletion allowance has already received a reduction through the years, while our biggest competitor, cement, enjoys a 15% rate on both the limestone and the clay or shale that is used at a kiln feed cut-off point. It is not right that we should suffer now under the cloak of fair play. Our industry is small. Any reduction of the clay depletion allowance would increase annual Treasury receipts very little, but would be a severe shock to my company and to all clay pipe manufacturers.

Clay pipe, as you know, is a quality material used in the great effort of our country to forestall the deadening effects of water pollution. It appears to be inconsistent to grant companies a fast tax write-off for constructing water pollution facilities and simultaneously to penalize their efforts by inducing the higher costs which will inevitably result from depletion allowance reductions.

Moreover, this is surely not in the interest of our country in its current struggle to contain 'nflation.

In view of the above comments, I respectfully urge you to take appropriate action to insure that the clay depletion allowance is not further reduced from its current rate of 7½%. Fire clay used in sewer pipe manufacture deserves, for equity, the same 15% depletion rate as the limestone and clay used in cement.

Sincerely yours,

CLARK SUTHERLAND, *President.*

SOME FACTS ABOUT PERCENTAGE DEPLETION FOR CLAY USED IN SEWER PIPE MANUFACTURE

Under earlier tax laws, refractory clay used in the manufacture of clay pipe was allowed the 15% rate. Justification for the 15% rate was fortified by Internal Revenue Ruling 56–59, which included these comments: "A clay will be considered a refractory and fire clay only if it is used or sold for use for a recognized refractory purpose." Under this new ruling, "fire clay, when blended with ordinary clay to produce vitrified clay sewer pipe, is considered to be used as refractory clay. In the view of the above, it follows that in determining percentage depletion application to clay, the end-use test must be employed. For example . . . clay use or sold for use as refractory clay is entitled to the 15% depletion." For some years, then, the Clay Sewer Pipe Industry explored for additional deposits in an atmosphere of some stability when, in 1960, almost without warning, clay used in sewer pipe manufacture was singled out for a decrease of its allowance to 5%, a reduction of 66.6%. (P.L. 86–564). In 1966, Congress agreed to a partial restitution, in response to a strong plea of equity, by raising the allowance to its current status of 7.5%. Under the provisions of H.R. 13270, this clay is once more to be reduced to 5%. Therefore, while all other minerals are to be reduced on a proportionate basis from their original allowances, clay is to be subjected to the same proportionate reduction from a base already 50% lower than its original allowance! Clearly, this is inequitable, by any standard.

The kind of clay used in the manufacture of vitrified clay sewer pipe demands refractoriness found only in certain fire clays. Thus, clay used in the manufacture of sewer pipe should be specifically included in the percentage depletion rate paragraph (501(b)(4)(B) in H.R. 13270) as a clay "used for purposes dependent on its refractory properties." Sewer pipe clays could surely rest their case for fairer treatment at this point, were it not for the fact that they have suffered added unfair treatment compared to their most active competitor—cement. Limestone and shale (clay) used as the basic ingredience of cement, have the 15% depletion rate. Unless some action is taken on behalf of clay used for the manufacture of sewer pipe, the "proportionate" reductions of H.R. 13270 will again strike the Clay Sewer Pipe Industry with disproportionate results.

Equity demands reinstatement of the Clay Sewer Pipe Industry's fire clay to a 15% depletion rate.

STATEMENT OF AMERICAN INDUSTRIAL CLAY CO. OF SANDERSVILLE, ENGELHARD MINERALS & CHEMICALS CORP., FREEPORT KAOLIN DIVISION OF FREEPORT SULPHUR CO., GEORGIA KAOLIN CO., J. M. HUBER CORP., AND THIELE KAOLIN CO.

This statement is filed by the following producers of china clay: American Industrial Clay Company of Sandersville, Engelhard Minerals & Chemicals Corporation, Freeport Kaolin Division of Freeport Sulphur Company, Georgia Kaolin Company, J. M. Huber Corporation, and Thiele Kaolin Company.

For the reasons set forth below, these companies are opposed to Section 501(a) of H.R. 13270, as passed by the House of Representatives, insofar as it reduces the 15 per cent rate of percentage depletion which has been applicable to china clay since 1947.

THE MINERAL

China clay (or "kaolin" as it is sometimes called) is one particular, comparatively scarce, variety of clay. Its unique properties make it a valuable raw material for many important industries. Its principal use is in paper, both as a coating and as a filler, but it also has a wide variety of other uses, including whiteware (porcelain, electric insulators, plumbing fixtures, etc.), certain refractories, medicines, and as a filler for rubber, paint, plastics, insecticides, and many other products. It is clearly distinguishable from the low grade, inexpensive clays which are found in many parts of the country, and, in fact, from all other clays, on the basis of the following characteristics: china clay has a clay mineral content of substantially pure kaolinite, it is white or nearly white or can be beneficiated to be white or nearly white, it will fire to a white or nearly white color, and it is amenable to beneficiation by known methods to make it suitable for use in whiteware, paper, rubber, paint, and similar uses.

SIZE OF THE INDUSTRY

The principal producing area for china clay in this country lies in a belt of rural counties in Georgia (principally Twiggs, Wilkinson, and Washington Counties) and South Carolina (Aiken County).

The china clay industry is small when compared to most other mining industries, but it is extremely important to the economy of the rural area of Georgia and South Carolina where it is located. China clay, in fact, accounts for about 47% of Georgia's mineral production value. The six principal producers submitting this statement, with a combined payroll cost of approximately $20,000,000, employ about 2,800 people, the great majority of whom live in this rural area. These six companies have invested more than $50,000,000 in paint and equipment during the past five years and more than $75,000,000 in the past 10 years.

DEVELOPMENT OF THE INDUSTRY

During the early part of this century, substantially all of the china clay used in this country was imported from England. The development of the domestic industry began in the 1920's; today, the Georgia and South Carolina area is the largest producing area in the world. The domestic industry now supplies practically all domestic needs and it also contributes to a favorable balance of trade by exporting substantial quantities. In order to achieve this growth, the producers were required to develop means to process the domestic clay to improve its color, which, in the ground, is not as white as the English clay and to provide the users of the clay with superior service. At the same time, they have worked with customers to develop new uses and to improve the technology of processing and utilizing the clay.

Accordingly, the present position of the industry is due in substantial part to the large sums spent by the industry on research and development, and the future success, and even survival, of the industry depend on continuing this work.

In addition, as the markets have grown and the specifications of customers have become stricter, the industry has had to spend large sums prospecting for additional deposits of suitable clay. Because of the ever shifting demands of customers, no company can be certain of the extent of its reserves; clay which is suitable for today's market may be unsuitable a year from now. Thus, the industry must constantly search for new deposits, at the same time that it seeks to develop new processing techniques to utilize known deposits.

THE IMPORTANCE OF PERCENTAGE DEPLETION

The amount of tax involved in the depletion deduction for china clay is negligible from the Government's standpoint, but it is extremely significant to this industry. Thus, in the past five years, the *total* annual tax saving, from percentage depletion, for the six major producers *combined* has averaged less than $3,500,000. The reduction to 11% adopted by the Ways and Means Committee would have reduced this amount, and increased revenues, by less than one million dollars a year. Obviously, such an increase in tax would have no noticeable effect on revenue collections or on curbing inflation. However, the increased tax resulting from this proposed reduction in the depletion rate would adversely affect the future of the small industry for the following reasons.

It must be realized, first of all, that any increase in tax will constitute an additional increased cost, which will be imposed upon the producers on top of increases in all other costs. Of course, all businesses are experiencing cost increases today, but such increases have been particularly severe for this industry. Thus, as the more accessible deposits of china clay have been exhausted, it has been necessary to remove more and more overburden to reach suitable clay, and to transport the clay farther and farther to the processing plants. The competition for suitable clay deposits has increased tremendously the cost of buying or leasing clay land. Over all, the expenditures by these companies for royalties and rents have more than doubled in ten years. In addition, recently enacted legislation requires the industry to incur substantial expenses for land reclamation, as well as for air and water pollution control.

Accordingly, the increase in taxes resulting from a decrease in depletion would be imposed on top of other escalating costs, and would further and materially reduce the profitability of the business at present price levels.

If the producers would try to offset that decrease in profits by increasing prices, they would face a loss of business, both here and abroad, to the English producers.

English China Clays, Limited, which controls vast reserves in the Cornwall district of England, is the largest producer of china clay in the world. The china clay production of this one company, which has total assets of $155,000,000 and sales of over 2,000,000 tons of china clay a year, is almost as large as that of the six major U.S. producers combined. It exports 75% of its production and has the know-how to supply all markets. The English producers have at least two cost advantages as compared to American producers: first, their labor rates are substantially lower than the rates in Georgia and South Carolina and, second, their deposits are adjacent to seaports so that they can load directly on to ships which provide low cost transportation to customers. In addition, the English producers enjoy a special advantage under British tax laws in that they receive rebates from the government of 40% of new capital investments in the china clay business.

During 1968, Canada and the United States imported 175,000 tons of china clay from England, having a value in excess of $4,000,000, whereas U.S. producers exported 389,000 tons valued at almost $13,000,000. All of these export sales are in direct competition with the English. The china clay industry has contributed to a favorable balance of trade, but any price increase resulting from a reduction in percentage depletion would allow a substantial penetration of the U.S. market by the English and would reduce substantially U.S. exports; obviously, there would be a substantial adverse effect on our balance of payments.

If the producers could not recoup the lost profits by increasing receipts, they would either have to reduce other expenses or be satisfied with a smaller return on their investment. Any program to reduce expenses, in order to compensate for the loss of depletion, would necessarily affect primarily non-production expenses such as exploration and research and development. A reduction of expenditures in either or both of these categories would, of course, slow or halt the search for suitable clays and prevent work on the development of new processing techniques and uses and thus affect adversely the future growth growth of the domestic industry.

If costs cannot be reduced, the producers' return on investment is lowered, and the additional tax cost is borne by the individual investors in the producing corporations who invested their money in this industry in reliance on the existing depletion allowance, which has remained unchanged for over 20 years.

Furthermore, the lower return means that less capital will be invested to expand present production and to utilize improved processing techniques. One of the major producers recently studied the possibility of constructing facilities to utilize reserves which it holds in the Sandersville area of Georgia. Its projections showed a return, after taxes, at current prices and with the present depletion deduction, of only 8.4% on an investment of over $10,000,000, obviously, such, such a return on investment is low today, especially in view of the high interest rates. Any reduction in this rate of return could well prevent further investment in this industry.

Although the proposed reduction in the depletion rate to 11% might not be sufficient in and of itself to dry up sources of capital, the resulting cost increase is substantial to these companies and this increase, together with other cost increases, would have a significant effect on earnings.

In addition, such a cut in the rate would, at the very least, cause the financial community to be wary of possible additional cuts, and the complete repeal of percentage depletion would reduce profits to such a point that it is doubtful that any funds would be available in today's money market, especially for the smaller producer. Thus, a study sponsored in 1966 by the Georgia Department of Industry and Trade and the U.S. Department of Commerce ("Mineral Resources of the Central Savannah River Area") reported that dry process operations (conducted by the smaller companies) are "only marginally profitable" and that in some cases "the profit margin lies within the depletion allowance." Accordingly, even a small cut in the depletion allowance might well result in eliminating or severely limiting future investment.

CONCLUSION

In summary, the domestic china clay industry, although small, contributes significantly to the economy of the Southeast and supplies a wide market with a unique product having many important uses in our present day civilization. The industry has been able, through research and outstanding service to its customers, to preempt markets (domestic and foreign) of foreign producers. Those foreign producers, however, still compete vigorously, and any increased tax caused by a reduction in depletion, especially when combined with other rapidly rising costs, would seriously impair the industry's ability to compete. The increased revenue, of less than $1,000,000, is of negligible significance to the Government, but is of critical importance to this industry.

Whatever may be the merits of cutting the rates for other minerals, where more tax is involved and where the effect on the industry may be less severe, Congress should retain the 15% rate for china clay, just as the Ways and Means Committee has done for oil shale and gold, silver, copper, and iron ores.

American Industrial Clay Company of Sandersville
Englehard Minerals & Chemicals Corporation
Freeport Kaolin Division of Freeport Sulphur Company
Georgia Kaolin Company
J. M. Huber Corporation
Thiele Kaolin Company

American Smelting & Refining Co.,
New York, N.Y., September 25, 1969.

Hon. Russell B. Long,
Chairman, Committee on Finance, U.S. Senate, New Senate Office Building, Washington, D.C.

Sir: Pursuant to the procedure set forth by the Committee on Finance in its press release of August 12, 1969, regarding Tax Reform Hearings, I am availing myself of the privilege of submitting a written statement in lieu of a personal appearance.

The principal area of the Tax Reform Bill of 1969 (H.R. 13270) on which I want to comment covers certain provisions pertaining to natural resources and foreign tax credit allowances. I believe that these provisions constitute a serious threat to the ability of the United States to meet its future mineral requirements.

The provisions to which I refer are those which would reduce present percentage depletion allowances for most minerals, and those which would alter the present method of computing foreign tax credits allowable. Specifically, my references are to Sections 501(a), 431 and 432 of the bill. I will also comment with respect to certain testimony of the Secretary of the Treasury presented to the Senate Finance Committee on September 4, 1969.

SECTION 501(a)—PROPOSED REDUCTIONS IN PERCENTAGE DEPLETION RATES

Under Section 501(a) of the bill, it is proposed to reduce percentage depletion rates for all minerals with the exception of gold, silver, oil shale, copper and iron ore from domestic deposits. The proposed reductions range from 26.1% in the case of lead and zinc and certain other minerals from domestic deposits to 33⅓% for certain clays, shale and slate. The House Ways and Means Committee Report on the bill justifies these proposed reductions on the grounds that "there is a need to strike a better balance than now exists between the objective of encouraging the discovery of new reserves and the level and revenue cost of percentage depletion allowances."

Having been associated with the non-ferrous metals industry for over 40 years, I have seen many changes in the technology of exploration for and development of new mines as well as in the operation thereof. I have also seen the appetite of the United States and other industrial nations for non-ferrous metals grow insatiably as standards of living throughout the world have continued to improve. Years ago, he United States was largely self-sufficient in the major non-ferrous metals and the discovery of easily accessible high-grade domestic deposits assured an adequate supply for an indefinite period.

Today the situation is vastly changed. The growth in population and the astounding advances in American technology, neither of which show any signs of tapering off, have brought about a level of consumption of non-ferrous metals which cannot be met by U.S. domestic production alone. The higher grade deposits have been largely mined out and the grade of ores currently being mined is constantly declining. The search for new mineral deposits has been intensified but the cost of such exploration has increased unrelentingly. So too, costs of mining low-grade deposits have risen. To recover the metal content from these deposits, it is necessary to mechanize the operation with expensive equipment.

The capital investment required to locate a new mine and bring it into production is formidable. In many cases, because of inaccessibility of the ore bodies, it is necessary to build roads or even railway facilities, power plants, auxiliary shops, piers, barges, housing areas, stores, schools and recreation facilities in addition to the stripping of the overburden, other mine preparation and the building of the concentrator mill. Large trucks for hauling crude ore to the mill may cost as much as $200,000 apiece.

It is no exaggeration to say that from the time the existence of a large non-ferrous ore body is determined by today's sophisticated but costly exploration techniques until the time when the mine starts to operate, total capital investment may run as high as $350,000,000. The time factor from discovery of ore in commercial quantities until the commencement of production may be from five to ten years which means that substantial sums of investment capital is sterilized, producing no return during the development and construction period.

When one considers such awesome cost factors plus the high risks involved in exploring for new ore deposits in the field of non-ferrous metals, it is difficult to see how we can achieve the necessary balance between estimated demand and estimated production in the future. It is expected that the population of the United States will be about 320 million people by the year 2000. It is also expected that consumption of minerals and metals on a per capita basis will increase with the result that demand will expand more than 4 times by the year 2000 over what it is today. At the same time, the Bureau of Mines has estimated that domestic production of these essential raw materials will be only about twice today's production by the year 2000.

In view of the foregoing facts and predictions, the conclusion of the House Ways and Means Committee in its report on H.R. 13270 is unacceptable. In commenting on the proposed reductions in percentage depletion rates, the report says, "These new percentage depletion rates will still provide substantial encouragement for the exploration and discovery of new reserves of oil and gas and the minerals concerned. Moreover, these new rates will be more realistic in relation to the need for such encouragement." Such a conclusion is illusory and completely inconsistent with the hard realities of the future supply-demand situation in the non-ferrous mining industry. I therefore recommend that the proposed reductions in percentage depletion rates be rescinded because they are incompatible with the desirable national objective of maintaining adequate mineral reserves.

SECTION 431—FOREIGN TAX CREDIT—LOSSES-RECAPTURE

Section 431 of the bill proposed that when a U.S. taxpayer, using the "per country" limitation, sustains losses in a foreign country which are deducted from domestic income, the tax benefit from the foreign losses is to be recaptured when income is subsequently derived from the foreign country. The House Committee Report states that the provision is needed to abolish a double tax benefit which is available under present law. Specifically, it is alleged that the double tax benefit occurs because in the year of the losses, the U.S. tax on domestic income is reduced by the losses, and then when the business operations in the loss country become profitable, a credit is allowed for the taxes paid in that country against what otherwise would be the U.S. tax on the income from that country.

Actually, there is no double tax benefit. Let us take the case of a taxpayer who develops a new mine in Arizona at a cost of $10,000,000 over a two-year period. He writes off this $10,000,000 against other income in his U.S. tax returns, thus reducing his tax liability by $5,000,000 (assuming a 50% tax rate for simplicity of explanation). In the third year, the mine is in operation and has taxable income of $5,000,000 on which it pays U.S. tax of $2,500,000. Now, assume the same facts, except that the mine is located in a foreign country. The $10,000,000 of development expense is written off in the U.S. tax returns with a resultant decrease in tax liability of $5,000,000. In the third year, the U.S. tax, before foreign tax credit, is $2,500,000, but assuming the tax rate in the foreign country is 50%, the taxpayer must pay $2,500,000 of tax to the foreign country which he claims as a credit against the U.S. tax. In both cases, the taxpayer has sustained the same losses, the same income and the same net tax effect, the only difference being that the tax payable in the case of the foreign mine went to the foreign government rather than to the U.S. This is as it should be. To propose a form of recapture of an alleged double tax benefit in the case of the mine located outside the U.S. would really result in double taxation.

Earlier in this letter, I referred to the fact that the U.S. is no longer self sufficient with respect to its requirements for many non-ferrous metals. We are dependent upon imports to supplement our domestic production of copper, lead and zinc and many other metals. At the same time, we must compete with other industrial countries in the world for foreign sources of supply. Many of these other countries do not tax income which has its origin outside their national boundaries. Certainly, taxes are one of the most important competitive factors in determining which countries will control foreign mineral resources. These resources are generally located in the less-developed countries and in Canada and Australia, and these countries have enacted tax incentives to encourage the development of their mineral resources. The industrialized nations of Europe have endeavored to adjust their own tax laws so that their citizens may take the fullest advantage of the tax incentives offered by the countries where the mineral deposits are located.

The effect of the U.S. tax laws, in contrast, is to nullify the tax incentives granted by mineral producing countries. The tax laws of some of these countries which grant incentives (such as lower income tax rates during the early period when the investment outlays are being recovered, or even complete exemption from income taxes during the early period of operation) provide for the elimination of the incentives where they merely divert tax revenues to the country where the investment originates. In other instances, even though the countries do grant the incentives, these incentives are completely offset by U.S. income taxes.

Section 431 of the House Bill, H.R. 13270, should be deleted. Not only is it aimed at curing a "phantom" double tax benefit which does not exist, but its enactment would be a further handicap and deterrent to U.S. mining companies in their search for foreign ore deposits which are so essential to our U.S. economy.

SECTION 432—FOREIGN TAX CREDIT LIMITATION WITH RESPECT TO FOREIGN MINERAL INCOME

Section 432 of the House Bill is directed at a presumed abuse of the foreign tax credit. The presumption is that where foreign taxes paid on mineral income exceed U S. taxes on such income, the higher foreign tax probably includes a disguised royalty payment which should not be allowed as a foreign tax credit against the U.S. tax on income from other sources in the foreign country. The House proposal sets up three tests and if any one of the tests are met, it is deemed prima facie evidence that the foreign income tax rate includes an element of hidden royalty. Under the proposal, this theory would be applied not only to foreign mineral income earned directly by a U.S. taxpayer but would also be applicable to dividened income from foreign mining companies to the extent the dividends were attributable to mineral income.

If a foreign country designates an impost as an income tax, it is inappropriate for the U.S. arbitrarily to redesignate a portion of the impost as a royalty. One of the tests proposed for the determination of whether the foreign income tax rate includes an element of disguised royalty is where the foreign country has substantial mineral rights with respect to property from which the foreign mineral income is derived. In many countries, under the law, the ownership of the mineral rights vests in the government, which grants concessions to private mining companies for long periods of time. Under the House Bill, in all such cases, any income taxes imposed would automatically be deemed to include a hidden royalty to the foreign government.

Section 432 of the bill is narrowly conceived and is not consistent with a broad policy of trying to assure that the U.S. has available in the future an adequate supply of metals to meet its requirements. It attempts to add an additional U.S. tax cost in the case of foreign mining operations, and hence it would make U.S. mining companies less competitive in the struggle to obtain control of foreign mineral deposits. For these reasons, this section of the House Bill should be deleted.

Comments on the Testimony of the Treasury Department Before the Senate Finance Committee—September 4, 1969

Under the House Bill, percentage depletion would be eliminated with respect to foreign oil and gas production. Also under the House Bill, it is proposed that the percentage depletion rates for gold, silver, copper, lead and zinc produced from deposits not located in the U.S. should be reduced from 15% to 11%.

In his testimony before the Senate Finance Committee on September 4, 1969, the Assistant Secretary of the Treasury for Tax Policy, The Honorable Edwin S. Cohen, recommended that the proposal to eliminate percentage depletion on foreign oil and gas production be deleted. The reason advanced for this recommendation was very sound. Mr. Cohen said, in part, "* * * after a brief period it will probably result in foreign countries increasing their effective tax rates on income from oil and gas production to "sponge-up" any additional tax revenue otherwise accruing to the United States. Thus the denial of foreign depletion will increase the effective U.S. rate of tax on such income, which tax the foreign governments will then offset by increasing their rates. The end result will be that the U.S. taxpayer will pay additional tax to those countries, but no additional tax to the United States."

Mr. Cohen has shown that he fully grasps the futility of eliminating percentage depletion with respect to foreign oil and gas production. I would like to submit that his very convincing reasoning has equal application to the proposed reduction in percentage depletion rates for gold, silver, copper, lead and zinc produced from foreign deposits from 15% to 11%. This proposed reduction, as Mr. Cohen says about foreign oil and gas deposits, "is unlikely to increase U.S. revenues significantly, and will merely increase the burden of foreign taxes on U.S. businesses." Many foreign countries also allow deductions for percentage depletion. These countries can be expected to reduce their percentage depletion rates promptly to coincide with any reductions in such rates made by the U.S. Those countries which do not have the concept of percentage depletion will, as Mr. Cohen has said, increase their effective tax rates to "sponge-up" the additional tax that would otherwise be payable to the U.S.

With respect to Section 432 of the House Bill, I was gratified to see that Mr. Cohen testified that the Treasury Department did not feel that it was proper to characterize all foreign taxes on mineral income in excess of U.S taxes on such income as disguised royalties. However, the Treasury Department recommended an alternative to Section 432 which would deny the use of excess foreign tax credits which result from the allowance of percentage depletion by the U.S. against other foreign income. The Treasury Department in its testimony before the Senate Finance Committee said, "We believe this rule will effectively deal with the problem of percentage depletion on foreign mineral production." In truth, there is no "problem of percentage depletion on foreign mineral production."

The Treasury Department, by its recommended alternative to Section 432 of the House Bill admits that U.S. taxation of foreign mineral income generally results in no tax revenue to the U.S. by its proposal to deny the use of excess foreign tax credits which result from the allowance of percentage depletion by the U.S. against other foreign income, the Treasury seems to be saying, "Let's see if we can't get some U.S. tax revenue out of smelting, refining or fabricating operations which the U.S. taxpayer performs abroad." This approach is like "grasping at straws", for it would merely encourage foreign countries to raise their tax rates on other than mineral income to "sponge-up" any additional tax revenue accruing to the United States.

In the course of his testimony on Section 432 before the Senate Finance Committee, Mr. Cohen said at one point, "We plan to present recommendations to Congress on this subject as a part of comprehensive proposals relating to the U.S. taxation of foreign source income which we are presently developing." Pending the announcement of these comprehensive proposals, it is untimely for the Treasury Department to foster piecemeal legislation of any kind in the field of U.S. taxation of foreign source income. I suggest that in the course of its study of the subject, the Treasury Department should keep in mind that unilateral actions taken by the U.S. in this field are unwise. Other sovereign nations can be expected to take corresponding retaliatory actions in their tax laws to prevent revenue from being diverted to the U.S. Treasury. The net result of this sort of contest is likely to be higher taxes for the U.S. company operating abroad with little or no additional revenue for the U.S. Treasury.

CONCLUSION

I submit that any proposed changes in our tax laws as they affect natural resources should not be considered solely from a revenue-raising viewpoint. A sound natural minerals policy for the future must contemplate appropriate tax incentives. If it does not, within 30 years the United States will find that it does not have the mineral resources needed to keep pace with its living standards and technological growth.

Respectfully submitted,

E. McL. Tittmann.

Statement of the Cement Industry Tax Committee of 1969, by Robert W. Fort, Chairman, Medusa Portland Cement Co., Cleveland, Ohio

Dear Mr. Chairman: I am writing on behalf of the Cement Industry Tax Committee of 1969, consisting of a majority of the producing capacity of the cement industry in the United States. The names of the companies supporting this statement are listed at its conclusion. The purpose of this letter is to present the position of the cement industry on matters of vital importance to it.

We join with and support the statement of the American Mining Congress presented to this Committee on September 30, 1969, with respect to the provisions of H.R. 13270 affecting the mining industry in general and the cement industry in particular.

However, the cement industry has a specific problem which is not dealth with in H.R. 13270 but which we believe merits the attention of the tax writing committees of Congress. We believe that legislation is necessary to correct an unwarranted reversal by government representatives of their previous interpretation of the law relating to the application of percentage depletion to the cement industry.

BACKGROUND

In 1951 Congress expanded the list of minerals eligible for percentage depletion. Included were calcium carbonates and other minerals utilized in the production of cement. The statute provided that the base for computing the percentage depletion allowance was "gross income from mining," which was defined to include ". . . not merely the extraction of ores or minerals from the ground," but also ". . . the ordinary treatment processes normally applied by the mine owners or operators in order to obtain the commercially marketable mineral product or products . . ."[1] One of the problems in the application of this statute involved the determination of what constituted "ordinary treatment processes" in the case of the so-called integrated producers who conducted both mining and

[1] Sec. 114(b) (4) (B), Internal Revenue Code of 1939.

manufacturing operations, such as the cement industry. As a result of discussions between representatives of the cement industry and the Internal Revenue Service, a ruling was issued in 1953 designating the end of mining at the point where raw materials are ready for introduction into the kiln for burning. At this stage, the raw mix is known as "kiln feed," which is never sold in commerce, and, thus, there is no representative market or field price which could serve as the measure of gross income from mining.

For such situations, Regulations had been promulgated under the 1939 Code in 1940 prescribing that a constructive gross income from mining be determined by means of a proportionate costs and profits computation.[3] That is, gross income from mining was considered equivalent to "the representative market or field price of the first marketable product resulting from any process or processes, minus the costs and proportionate profits attributable to . . . processes beyond the ordinary treatment processes." Thus, the object of the computation in the cement industry is to move from the known, the selling price of the first marketable product, to the unknown, a constructive selling price of kiln feed, by subtracting from the former the costs and proportionate profits applicable to the manufacturing processes. Up until the time the government changed its administrative practice in the early 1960's, as discussed below, the proportionate profits computation had been *traditionally applied on the basis of direct mining processing and direct manufacturing processing costs.*

Although disputes arose between the mining industry and the government during the 1950's as to where mining processes ended for depletion purposes, in 1960 the U.S. Supreme Court settled the matter for past years in its decision in the *Cannelton* case (*U.S.* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76), holding in effect that integrated miner-manufacturers should compute their gross income from mining on the same basis as their nonintegrated miner counterparts. This problem was resolved for years after 1960 by the enactment shortly thereafter of the Gore Amendment on June 30, 1960 (Public Debt & Rate Extension Act of 1960, P.L. 86–564), fixing the cutoff points for all minerals. The cutoff point for cement was set at the same point as provided by the 1953 ruling. At this time, the representatives of the cement industry believed that the controversy with the government was at an end because the method for computing percentage depletion at the cutoff point had been well established. And indeed a number of cement companies were able to settle their differences with the government utilizing the proportionate profits computation based on the long-standing practice of utilizing in the computation only direct mining and manufacturing processing costs. Thus in 1960 the cement industry had every reason to expect that the proportionate profits workback computation would be applied on the same basis as in the past.

CEMENT'S SPECIFIC PROBLEM

In the early 1960's the government reversed its prior application of the proportionate profits computation by erroneously insisting that certain additional costs be included in the computation as manufacturing costs which are not manufacturing costs, such as transportation and selling costs. This reversal of prior practice resulted in a substantial reduction in the depletion allowance and immediately precipitated numerous administrative and judicial controversies, many of which have continued to this date.

Because of the complexity of the subject and the highly technical nature of the computation, the courts have come up with a variety of interpretations for applying the proportionate profits computation. The result of these interpretations has caused considerable uncertainty for the industry, with some cement companies having their tax status open as far back as 1951.

Recently the Treasury Department has attempted to deal with this problem by regulatory action, and final regulations were issued in 1968 dealing partially with the proportionate profits computation. However, the 1968 regulations continued to ignore prior administrative practice and were met by large-scale protests from the mineral industries. Some relaxation of the harsh results of the 1968 version

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[3] See Regs. 118, Sec. 39.23(m)–1(e)(3).

was contained in a discussion draft published on March 27, 1969, which, however, has no legal effect and the 1968 regulations continue as the official Treasury position.

Although there are several different items of costs involved in the dispute, the cement industry, in order to put an end to the controversy, wishes to concentrate on the two most important items, i.e., *transportation costs* paid to third parties for shipping cement to customers, either directly or through a terminal, warehouse, or other distribution facility (described herein as purchased transportation to the customer) and *selling expenses* (including trade association dues).

TECHNICAL EXPLANATION OF THE PROBLEM

In the early 1960's the government changed its position to include in the proportionate profits computation as manufacturing costs certain items that had never been so included before. With respect to the two items discussed, the government contended that the cost of purchased transportation to the customer and selling expenses should be treated as manufacturing costs, allocating profit thereto. The cement producers contended that the Treasury's prior administrative practice was a correct interpretation of the law. The prior practice was that (a) the cost of purchased transportation should reduce the selling price of the first marketable product without attributing profit thereto, and (b) selling expenses be spread between mining and manufacturing in proportion to the direct processing costs thereof.

In the cement industry, it is the predominant practice for producers to prepay the cost of transporting the cement to customers so that, in effect, cement is sold on a "delivered price" basis rather than f.o.b. plant or terminal.

The formula for determining "gross income from mining" as set forth in the 1968 regulations:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Selling price of first marketable product}$$
$$= \text{Gross income from mining}$$

requires the cost of such transportation be included in the denominator, with the result that the producer is treated as having earned a profit on such purchased transportation, even though, on the face of it, would be impossible for the producer to make a profit from the customer by charging him more for public transportation than the customer would have to pay if he bought the transportation directly. It is interesting to note that if one accepts the government's contention that the cement industry makes a profit from transportation, then the producer shipping the greatest distance would make the largest profit. In fact, however, the direct opposite result occurs. The fallacy in the contention that cement producers make a profit on purchased transportation to the customer is established by the fact that after the product is shipped only a few hundred miles the cost of transportation is equal to the value of the cement. If a producer is to penetrate his competitor's market area, he must meet his price. If he ships cement farther than his competitor, he will pay more for the transportation and therefore realize less for his product. This, of course, results in a lower rather than a greater profit.

Secondly, the government contends that expenses incurred to sell cement should also be included in the denominator of the proportionate profits fraction, with no part thereof treated as allocable to mining.[3] It is clear that such expenses relate to the entire product, both mined and manufactured, and are incurred to dispose of the product, not to create it. Obviously, there can be no gross income of any kind, mining or nonmining, without sales and the consequent costs thereof. Selling expenses should be treated like general and administrative expenses, which the government concedes should be allocated to

[3] While there is recognition in pending proposed regulations that at least some portion of selling expenses should be attributed to mining, the portion would not exceed half of the amount allocable on a pro rata basis. There is no certainty that the proposed regulations will be finalized and, furthermore, the Justice Department in litigating is opposing any allocation by an automatic formula.

both mining and manufacturing operations. A substantial part of the industry's selling expenses represents dues paid to trade associations, such as the Portland Cement Association.[4]

REQUESTS FOR CONGRESSIONAL ACTION

The cement industry requests that members of the Senate Finance Committee consider the enactment of an amendment to the Tax Reform Act of 1969, which is intended to end this long controversy between members of the cement industry and the government.

The proposed amendment should provide that if the proportionate profits method is used in computation of gross income from mining (1) purchased transportation to the customer rendered by an unrelated party, such as a common or contract carrier, be subtracted from the selling price of the first marketable product in determining the gross income therefrom, and that no profit shall be allocated to such transportation in the computation; and (2) selling expenses, like general and administrative expenses, be allocated between the mining and nonmining phases of the business in the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other.

SUMMARY

Currently, long after the mining cutoff point for the cement industry was fixed by statute, the industry and the government are unable to agree on the calculation of gross income from mining for the purposes of computing the percentage depletion deduction. Unfortunately, the reversal of prior administrative practices by the government has cause a seemingly unending controversy between the government and industry over this matter. The cement industry is firmly convinced that the only way to bring this wasteful dispute to a conclusion is by requesting Congress to enact amendatory legislation which will state clearly and concisely the manner in which the proportionate profits computation is to be applied.

Respectfully submitted.

CEMENT INDUSTRY TAX COMMITTEE OF 1969,
By ROBERT W. FORT, *Chairman*.

Representing the following cement producers:

Alpha Portland Cement Co., American Cement Corp., Ash Grove Cement Co., Columbia Cement Co., Division of PPG Industries, Inc., The Flintkote Co., General Portland Cement Co., Huron Cement Division of National Gypsum Co., Ideal Cement Co., Kaiser Cement and Gypsum Corp., Keystone Portland Cement Co., Lehigh Portland Cement Co., Lone Star Cement Corp., Louisville Cement Co., Marquette Cement Manufacturing Co., Martin Marietta Corp., Missouri Portland Cement Co., The Monarch Cement Co., Monolith Portland Cement Co., Northwestern States Portland Cement Co., Southwestern Portland Cement Co., Universal Atlas Cement Division of U.S. Steel Corp., and The Whitehall Cement Manufacturing Co.

STATEMENT OF THE STRUCTURAL CLAY PRODUCTS INDUSTRY DEPLETION COMMITTEE, WASHINGTON, D.C.

MEMORANDUM IN SUPPORT OF A 15-PERCENT DEPLETION ALLOWANCE FOR BRICK AND TILE CLAY

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[4] Pending proposed regulations recognize the principle of allocating trade association dues to mining.

I. Summary Statement

This statement is being presented in behalf of the approximately 467 brick and tile manufacturers to request a *correction of an inequity* in both the rate of the depletion allowance now granted our industry and the point of application of that rate in computing the allowance. We are currently operating under most inequitable legislation starting with the Gore Amendment to the Public Debt and Tax Rate Extension Act of 1960 which was enacted without any hearings being permitted our industry to express our views or to point out the inequities created. The Gore Amendment eliminated the previously court accepted principal of "first commercially marketable product" and by establishing the arbitrary "cut-off" point at the pug mill destroying about 80% of the depletion established for brick men by previous legislation and court decisions. This most drastic action has been a serious blow to the progress and economic stability of our entire industry.

In 1963 we requested the Congress to rectify these inequities and after hearings the Senate voted a rate of 15% allowance to clay which was the same as limestone but failed to modify the cutoff point. When the bill was considered in conference, the conferees went only part way in rectifying the inequity by raising clay from 5% to 7½%, *not* to the *15%* allowed limestone for cement.

The clay industry has been laboring under this inequity for the past six years because the Congress has refused to consider any amendments to the Depletion legislation.

Now with consideration being given to a tax reforms bill depletion allowances are also being reconsidered and the inequity between limestone and clay used for brick and tile should be eliminated.

Another potential inequity has been created between clay and other minerals in the pending House bill H.R. 13270. An effort has been made by the House of Representatives to cut oil depletion allowance from 27½% to 20% or by 27.2%.

However in cutting clay depletion allowance and in order to arrive at a round figure, 5% was given clay resulting in a 33% cut, which is a much larger percentage cut than the 27.2% cut in oil depletion.

Here again limestone was cut from 15% to 11% which is only 26.6%. This also continued the inequities of clay against limestone used for cement. Our request is that brick and brick and tile clay be increased in rate from 7½% to 15% and that the point of application of this rate be, instead of at the pug mill, applied at the point of entrance into the kiln which would give us the same depletion now enjoyed by our most direct competitor, cement. Today in the marketplace of construction, the principal competition for the wall treatment lies between the cement and burnt-clay producers. Cement, under the depletion allowed limestone, is favored by a 15% rate and by application of this rate at the point much further along the line of production than that allowed clay producers under the Gore Amendment. We have charts which illustrate certain points of direct comparison between clay and cement. The first illustrations show the origin and formation of clay and limestone (Figs. 1, 2 and 5). Nature has been generous in creating limestone of the types used in cement making compared with the stingy distribution of clay. This map (Fig. 3) illustrates comparatively, the relative abundance and scarcity of the two minerals. We also show on this map (Fig. 4), the wide distribution of clay plants which must locate on clay beds for their raw materials and near markets because of the mass and weight of clay and its products involved in costly transportation. Fig. 6 shows the number and location of cement plants.

It can be seen that usable brick and tile clay is scarce in nature. Compounding this scarcity is the inexorable spread of civilization. As towns in America located along rivers, grew up, and spread out, they covered vast areas of valuable clay deposits, removing them forever from use. Today, science is being drawn on more and more in the constant search for suitable clays.

Though unevenly distributed, clay is found in many parts of the country. Because of this and the fact that clay's heavy mass which is a very low-priced commodity, limits the shipping distance and the marketing area for a given manufacturer's products, the U.S. structural clay products industry is decentralized in a large number of relatively small plants.

In a typical case, a manufacturer will locate his plant at or near the clay pit to minimize transportation costs. Since the clay from that pit will have a unique color and texture that cannot be duplicated with other clays, that manufacturer is out of business once that deposit has been exhausted. He then must locate a new deposit, build another plant, and begin all over again with an entirely new product.

Whereas suitable clay is scarce, limestone of the quality used in cement manufacture is a sedimentary rock of wide distribution. Usually of marine origin, it frequently consists of calcium carbonate derived from sea shells formed and deposited on ocean floors over eons of time. Such shells, in fact, are still recognizable in many limestone deposits. In others, their derivation has been obscured by the action of waves and currents and by chemical action.

Limestone occurs on every continent in formations ranging from a few inches in thickness to hundreds of feet. It is especially abundant in the eastern two-thirds of the U.S., which was once awash beneath ancient seas. Geologists and mining engineers, in fact, estimate that limestone of the quality used in cement plants is much more abundant in the U.S. than is clay.

Limestone is the chief constituent of hydraulic (portland) cement, which provides the structural clay products industry with its chief competition in every building market, as shown in the Figure No. 7. The competitive imbalance between the two minerals is obvious: the scarcity of brick and tile clay and the problem created by its varying composition contrasted with the abundance of limestone and the fact that variations in quality of limestone when used for such purposes present less problems.

Fig. 9 illustrates most clearly the similarity of the steps of production of clay products and of cement. It shows also how much more of the production process is permitted depletion application in cement than in a clay product. Our request is for the granting of depletion on clay production processing equal to that allowed cement producers. Fig. 7 is displayed to illustrate the direct competition of the clay products to the cement products. We call your attention to the almost exact horizontal product mix of each of these industries. As you see, item by item, they offset each other. As you see also, from (Fig. 8), ours is a small competitor in total dollar volume of business, number of employees, and size of plants.

We are that "small business" group that form the economic background for many small communities over the nation. Relief from the present depletion restrictions would render needed stimulus to this cause of small producers. We realize that much testimony will be presented directed to the *maintenance* of present rates and depletion allowance. In the interest of equitable tax revision, we feel it is equally urgent to request for our industry restoration of a part of our denied depletion and to urge equity in adjusting our rate to overcome the competitive disadvantage placed against us. We will appreciate your consideration.

II. Brick and Tile Clay

Origin

As has been seen, clay is the random creation of glaciers, wind, and water interacting on ancient rocks (Figs. 1 and 2). Clay occurs in three principal forms, all of which have similar chemical compositions but different physical characteristics. They are: Surface clays, which may be the upthrusts of older deposits or of more recent sedimentary origin; shales, which are clays that have been subjected to intense pressures until they have hardened to a slate-like consistency; and fire clays, which usually contain fewer impurities than shales or surface clays and which have more uniform chemical and physical properties.

Very thorough testing of clay reserves must be undertaken to predict their performance in advance. This work entails a great deal of time and money and is becoming increasingly necessary as known reserves dwindle.

Properties

Clays are complex materials, surface clays and fire clays differ from shales more in physical structure than in chemical composition. Chemically, all three are compounds of silica and alumina with varying amounts of metallic oxides and other impurities. Although, technically, metallic oxides are impurities, they act as fluxes, promoting fusion at lower temperatures. Metallic oxides influence the color of the finished product.

To satisfy production requirements, clays must have plasticity which permits them to be shaped or molded when mixed with water and they must have sufficient tensile strength to maintain their shape after forming and drying. When subjected to certain temperature ranges, the clay particles must fuse together. In addition, uniform density, hardness, and regularity of form are necessary.

To control as much as possible any variations in the end product, manufacturers often adjust various ingredients. For example, silica will reduce shrinkage in the kiln, but too much will reduce the cohesion of the clay Lower fusion temperatures can be made possible by the inclusion of carbonate fluxes, but they have a strong effect on color, as does iron oxide, which improves strength.

Scarcity

Usable brick and tile clay is scarce in nature and becoming scarcer as known deposits are exhausted and the urbanization of America continues to spread out over usable deposits, removing them forever from use. Available brick and tile clay in the U.S., in fact, is estimated to be many, many times scarcer than limestone suitable for cement manufacture (Fig. 3).

Mining and Manufacturing Processes

Once a clay deposit has been located, tested, and found suitable for brick and tile manufacture, the mining process begins. Surface clays and shales are mined in open pits through the use of power shovels or shale planers. Some blending of raw materials is done at this stage to obtain a uniform composition. A shale planer helps to get a well-blended mixture since it makes a uniform cut from top to bottom of the bank.

Once dug, the clay or shale mixtures are transported to storage bins in the plant, either by trucks or by rail. Raw materials equal to several days' production usually are kept in reserve.

The first step in processing clay is crushing, which breaks up large chunks and removes any stones that might be present. Crushing is done either in a granulator or by heavy conical rolls.

The clay next is ground in any of several types of grinders. In a typical grinding operation, huge wheels weighing 4 or 5 tons each revolve in a circular pan filled with clay, grinding and mixing as they pass. At this point, some plants then screen the clay by sifting it through an inclined vibrating screen. The clay is now ready for tempering.

The object of tempering is to process the clay into a homogeneous and plastic mass ready for molding into units of a desired shape. This is most commonly done by adding water to the material in a pug mill. The pug mill consists essentially of a chamber within which revolve one or two shafts with blades or knives which thoroughly reduce and mix (called pugging) the material.

Now the clay is ready to be formed, and one of two principal methods is used – either the "stiff-mud" or the "soft-mud" process, depending on the qualities of the clay itself.

In the stiff-mud process, the clay is delivered to an auger machine which forces the plastic mass out through a molding die in a continuous stream called a column, much like toothpaste from a tube. The die molds the mass into the desired shapes for brick, hollow tile or other forms and, as the column is extruded, it passes through a machine which cuts it into the desired lengths. In the size of the die and in cutting to length, allowance is made for the shrinkage that will result from drying and burning.

De-airing is an important development in the stiff-mud process. It is accomplished by use of a de-airing chamber attached to the auger machine, through which the clay passes. The clay is broken up and shredded as it enters this chamber, where a vacuum of from 15 to 29 inches of mercury is maintained. Some of the chief advantages of de-airing are greater strength in the body both before and after firing, increased workability and plasticity, and better utilization of inferior clays.

The soft-mud process is used only for brick and is particularly well-suited to clays which contain too much water in their natural state to be used in the stiff-mud process. The soft-mud process mixes clays with 20 to 30 per cent water. When tempering is completed, the clay is pressed into molds by an automatic machine which sends the molds, presses the clay in, strikes off the excess, "bumps" the molds and deposits the molded brick onto pallets for drying.

In order to prevent the wet clay from sticking, the insides of the molds are either covered with a thin layer of sand or are dipped into water before the clay is pressed into them. Both "sand-struck" and "water-struck" brick derive from this process. Each method produces a characteristic surface texture.

Other brick finishes are provided by machine attachments which will scratch, roll, brush, or otherwise roughen the surface of the clay leaving the die.

After the brick or tile units are formed they must be dried before burning. As the units move off the cutting table, they are loaded onto dryer cars so that air can circulate freely around them. There are many different types of driers, but the purpose of any drier is to remove as much free water from the units as possible in the shortest possible time. The time required will vary with different clays but usually is from 24 to 48 hours. The heat and humidity in the dryer tunnels must be closely monitored during this period to prevent excessive cracking which would destroy the units.

A third method of manufacture, very little used in brick and tile manufacture today, is the "dry press" process where clay in a nearly dry state is molded into shape under high pressure.

Burning is the next step in the manufacture of structural clay products and requires from 60 to 100 hours to complete. Several types of kilns are used, including scove, round periodic down-draft, and tunnel kilns. Fuel may be coal, oil, natural gas or, in some cases, wood.

In the scove and periodic down-draft kilns, the dried units are set by hand according to a prescribed pattern that permits the free circulation of hot kiln gases. In a tunnel kiln, the units are loaded on special rail cars that move through the tunnel at a regulated speed.

The burning or "firing" of clay products may be divided into three general stages: dehydration or "water-smoking"; oxidation or "blue-smoking," and partial vitrification or "hardening." These stages accompany rising kiln temperatures and produce certain physical changes in the units. Temperature and the rate of temperature increase must be carefully regulated according to the type of unit and the characteristics of the clay. All kilns are equipped with recording pyrometers so that the burner can have a constant check on the firing process.

After maximum temperature has been reached, the kiln is allowed to begin cooling gradually. Sometimes this is preceded by "flashing," a step which involves creating an atmosphere in the kiln insufficient for complete combustion. Done skillfully, flashing will produce different colors and shades of colors, depending on the type of clay being fired. Cooling usually takes 48 to 72 hours and the rate of cooling has an important effect on color, while units cooled too rapidly will crack and check.

After cooling the kiln is unloaded, the units are sorted and graded, and either loaded directly for shipment or sent to storage.

Clay Depletion Allowance

Minerals in the ground, whether solid, liquid, or gas, are a form of capital. When a mineral such as clay is extracted from the ground, the value of that clay deposit is to that extent depleted. And at the same time that the clay products manufacturer is depleting his mineral deposit, he is also depleting his plant, and he is also depreciating the expenditures he makes to promote the particular clay products coming from a particular clay deposit.

Congress more than 40 years ago recognized the depletion problem that faces producers in extractive industries when it enacted a "discovery value" depletion provision in the Federal income tax law. This was followed several years later by a more practical percentage depletion allowance, which continues in force to the present. In addition to the compensation of producers for the exhaustion of their reserves, the granting of depletion allowances also encourages the search for new reserves. This contributes to national wealth and purpose.

By the Revenue Act of 1951, the mineral "brick and tile clay" was, for the first time, granted a depletion allowance. That rate was limited to 5 per cent of the gross income from mining. That depletion allowance and the point at which it was applied was carried forward without change into Section 613(b)(5) of the 1954 Code.

Why should a depletion allowance for brick and tile clay be applied at a point in the manufacturing process, rather than when the mineral is extracted from the ground? The answer to that question can be found in the following definition of "gross income from the property." It was written into Section 114(b)(4)(B) of the 1939 Code by the Revenue Act of 1943:

> "As used in this paragraph the term 'gross income from the property' means the gross income from mining. The term 'mining' as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but *also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products (emphasis added).*"

The same language was carried forward without change into Section 613(c) of the 1954 Code.

In the Senate Report that accompanied the above quoted provisions of the Revenue Act of 1943, the Senate Finance Committee stated:

> "The purpose of this provision is to make certain that *the ordinary treatment processes which a mine owner would normally apply to obtain a marketable product shall be considered as a part of the mining operation (emphasis added)*. . . The law has never contained such a definition, and its absence has given rise to numerous disputes. The definition here prescribed expresses the congressional intent of these provisions as first included in the law. . . . It is therefore made retroactive to the date of such original provisions."

The intent of Congress in granting a depletion allowance to brick and tile clay therefore was that it be applied at that point in the mining-manufacturing process where the first *commercially marketable mineral* was produced.

This was well understood by Senator Walter F. George, of Georgia, who was Chairman of the Senate Finance Committee when the depletion allowance for brick and tile clay was written into the Revenue Act of 1951. In a letter dated June 4, 1955, to T. Coleman Andrews, then Commissioner of Internal Revenue, Senator George said:

> "I personally recall the discussion in executive session between members of the Senate Finance Committee when this statute was under consideration. At the time it was not only understood but I pointed out what I knew and believed to be the facts about brick manufacture. . . . Brick clay at this time has no commercially marketable value until it is baked or cooked. The Senate Finance Committee certainly understood this clearly before the (1951 Revenue) Act, giving depletion allowance to brick clay, was passed. . ."

Regardless of the law and Congressional intent, the Internal Revenue Service refused to recognize the "first commercially marketable product" as a finished brick or tile and clay manufacturers were forced to lengthy and expensive litigation in Federal courts to establish the right to a proper depletion allowance for the brick and tile clay. Over fifty Federal court cases were brought, including one Supreme Court case involving brick and tile clay. This litigation extended over a period of some 10 years. While the clay manufacturers were successful in all of these cases, the Internal Revenue Service refused to recognize the court decisions.

Finally, in a Supreme Court case involving depletion allowance on clay used for clay sewer pipe, the United States Supreme Court rendered a decision adverse to the sewer pipe manufac' .rer. Almost simultaneously, Congress enacted the so-called "Gore Amendment" (Public Law 86-564, 26 USC 611, Ju.ie 30, 1960), modified the Revenue Acts of 1951 and 1954 concerning clay depletion, and applied the 5 per cent depletion allowance at the point after "crushing, grinding and separating the mineral from waste, but not including any subsequent process. . ." – in other words, at the pug mill, a point at which clay is not salable and never has been. In 1963 in an attempt to rectify the inequity existing between clay and limestone used for cement the rate was raised from 5% to 7½% which only partially removed the inequity.

Since brick and tile has no determinable value at this point, a 7½ per cent depletion allowance recognized at this point can not be calculated without using some mathematical formula.

As shall be seen in a succeeding section, Congress has visited a double inequity upon the structural clay products industry in both the *rate* of depletion granted brick and tile clay and the *point* in the production process at which depletion is reckoned, as compared with limestone, the chief constituent of hydraulic (portland) cement, which provides the structural clay products industry with its chief competition (Fig. 9).

Number of Brick and Tile Clay Plants, Their Distribution, Number of Employees, and Dollar Volume

At the present time there are an estimated 467 companies of relatively small size producing structural clay products (Fig. 4). Their products include brick, hollow tile of all types, and architectural terra cotta, but do not include thin wall tile, sewer pipe, flue linings, or drain tile. Types of brick include building brick, facing brick, sewer brick, paving brick, and glazed brick. Hollow masonry units include structural clay tile and structural facing tile, both glazed and unglazed. Architectural terra cotta includes ceramic veneer and ornamental sculpture.

These plants occur in every state, but concentrate in such relatively clay-rich states as Illinois, Indiana, Iowa, Ohio, Pennsylvania, New Jersey, North Carolina, and Texas.

The 467 structural clay products companies employ an estimated total of 37,300 workers, largely in production. The estimated total value of brick and tile shipments in 1968 was $516,000,000 (Fig. 8).

III. Limestone

Origin

Limestone is a whitish rock usually of organic origin (Fig. 5). Much limestone is composed almost entirely of shells, shell fragments, or the remains of other sea creatures. The origin of other limestone deposits is often difficult to determine.

Properties

Except in the case of relatively small amounts of high purity limestone used for chemical and metallurgical purposes, the relative purity of limestone is not too important in determing its use. Because of this and its great abundance, limestone is widely used for a great number of purposes.

Abundance

Limestone occurs on every continent and provides ample evidence of the extent to which the seas once covered the land. In the U.S., limestone is especially abundant in the eastern two-thirds of the country. Geologists and mining experts estimate that limestone of the quality suitable for cement manufacture is much more abundant in the U.S. than is clay (Fig. 3).

Mining and Manufacturing Processes

Limestone is quarried by blasting, then loaded and transported to crushers. If intended for use in cement manufacture, shale is added at that point, usually in the proportion of one part shale to four parts limestone. After the limestone has been crushed and sifted through a vibrating screen, it is next pulverized in a hammer mill and stored.

Limestone is the chief mineral used in the manufacture of portland cement. In modern manufacture, a suitable mixture of limestone, shale, and other minerals is ground together either wet or dry in the proper proportions. If mixed wet, the resultant slurry is pumped into a series of large mixing tanks and from there it is pumped into the kiln. If mixed dry, the ground raw material is carried by a conveyor to storage bins, and from there it is fed into the kiln after it has been damped to control dust.

In either form the raw material enters the kiln at the top end close to the chimney and is met by hot gases. The raw materials thus are dried and, as the kiln revolves, they fall downward toward the clinkering zone. There, under high heat, elements of the limestone and shale partially fuse or "clinker" together. The clinker is removed, cooled, mixed with a little gypsum or water to regulate the setting time, and then is ground to the finished product – portland cement.

Limestone Depletion Allowance

Like brick and tile clay, limestone has enjoyed a percentage depletion allowance since 1951. Unlike brick and tile clay, however, limestone used in making cement has enjoyed a substantially higher depletion percentage – 15 per cent – and that percentage has been applied at a point in the portland cement manufacturing process – at the "introduction of the kiln feed into the kiln" – at which the portland cement industry enjoys a substantial tax benefit (Fig. 9).

Number of Portland Cement Plants, Their Distribution, Number of Employees, and Dollar Volume

Portland cement plants are relatively few in number, represent a considerable capital investment, and lend themselves to automated processes (Fig. 6). These facts are reflected in Department of Commerce figures which show that, at the end of 1962, there were only 188 portland cement plants operating in the U.S., yet their value of shipments totaled $1,238,133,000, although the estimated number of workers employed was only 33,000 (Fig. 8).

Because the location of portland cement plants reflects high construction volume as well as available limestone deposits, the bulk of such plants is in the eastern half of the U.S. and on the West Coast.

IV. The Directly Competitive Nature of Structural Clay Products and Portland Cement

Portland cement provides the chief competition for the structural clay products industry in every one of its markets (Fig. 7). For every structural clay product there is a competitive concrete unit, assemblage of units, or application. Portland cement and its end products are also very competitive with structural clay products in price.

Contrasted with the portland cement industry's relatively few plants and large dollar volume, the structural clay brick and tile industry is composed of a large number of taxpayer companies located in every one of the 50 states. These small independent businesses compete with each other under highly competitive conditions and, therefore, it is traditionally an industry which operates with a very small margin of profit.

Consequently, any factor which creates for one of those businesses a substantial disadvantage in comparison with its competitors may well prove disastrous to that business.

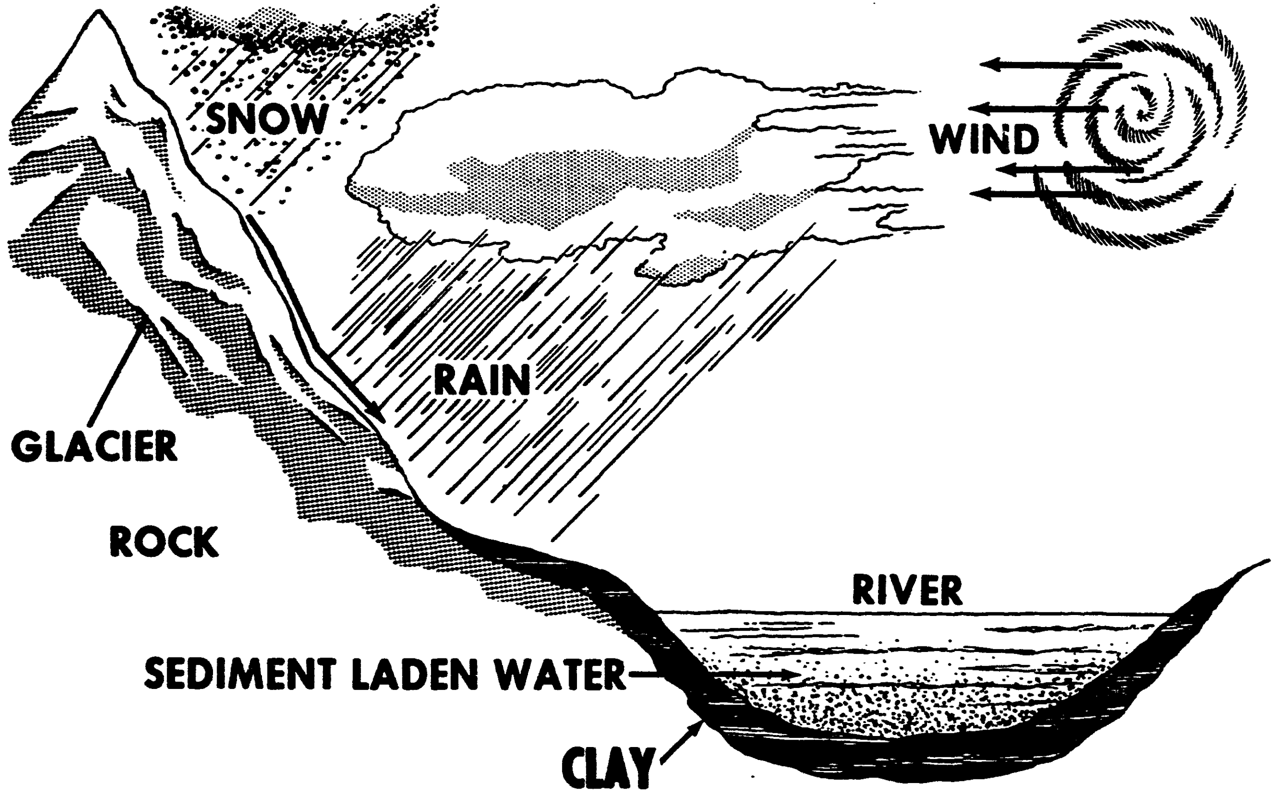
V. **Conclusion**

It is respectfully requested that Congress correct two serious inequities that presently exist in the application of depletion allowances to brick and tile clay and to limestone used in making cement.

First, the structural clay products industry requests that the present 7½ per cent depletion allowance granted brick and tile clay be increased to 15 per cent to remove the competitive advantage now given limestone, which enjoys a 15 per cent depletion rate.

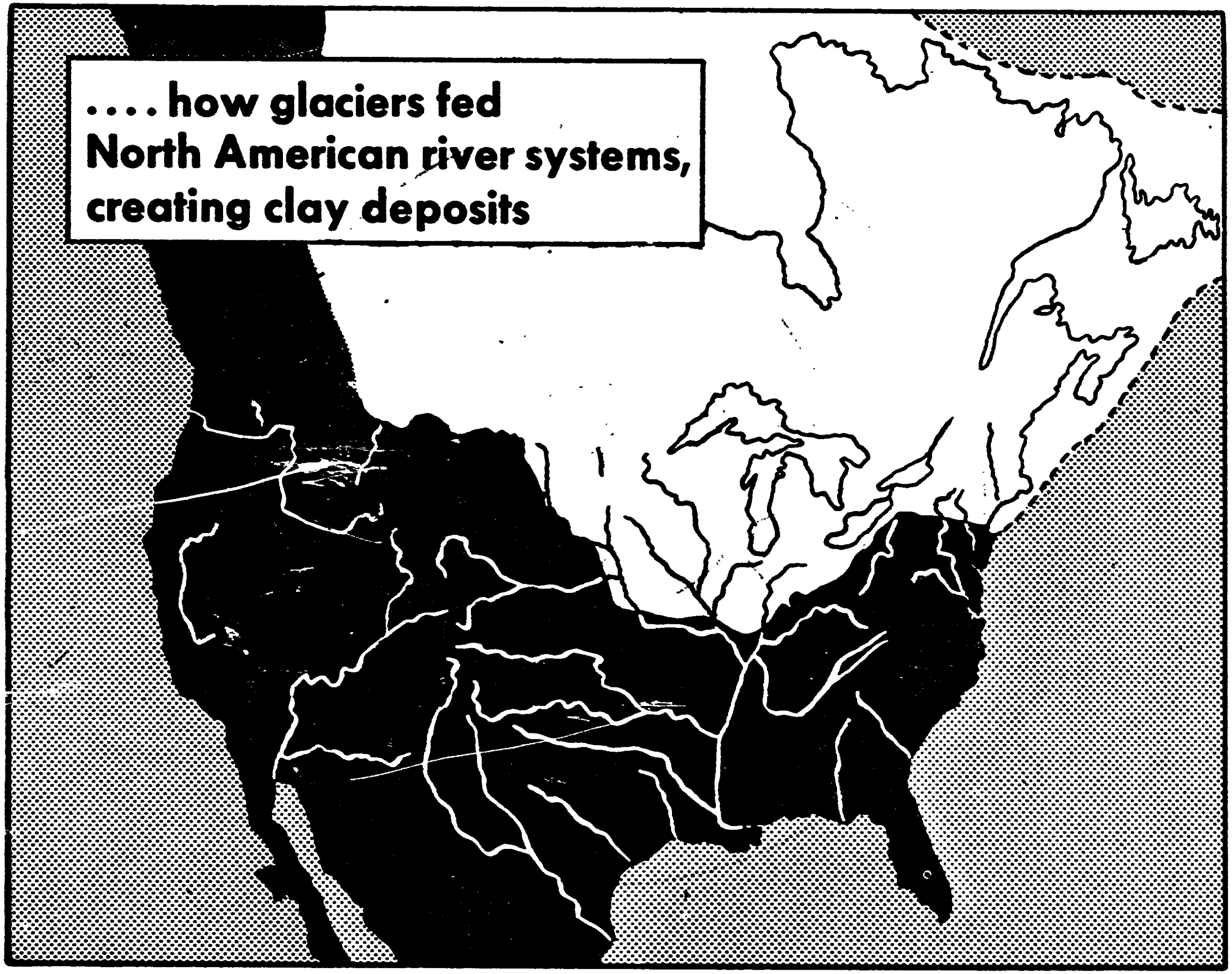
Second, it is requested that the point in the production process at which the clay depletion allowance is applied be advanced from the pug mill to the "introduction of the kiln feed into the kiln," which is the point just before the minerals are burned and the point at which the 15 per cent depletion allowance for limestone currently used in cement manufacture is reckoned.

With these inequities removed, the delicate competitive balance that has existed between the structural clay products and the portland cement industries will have been restored.



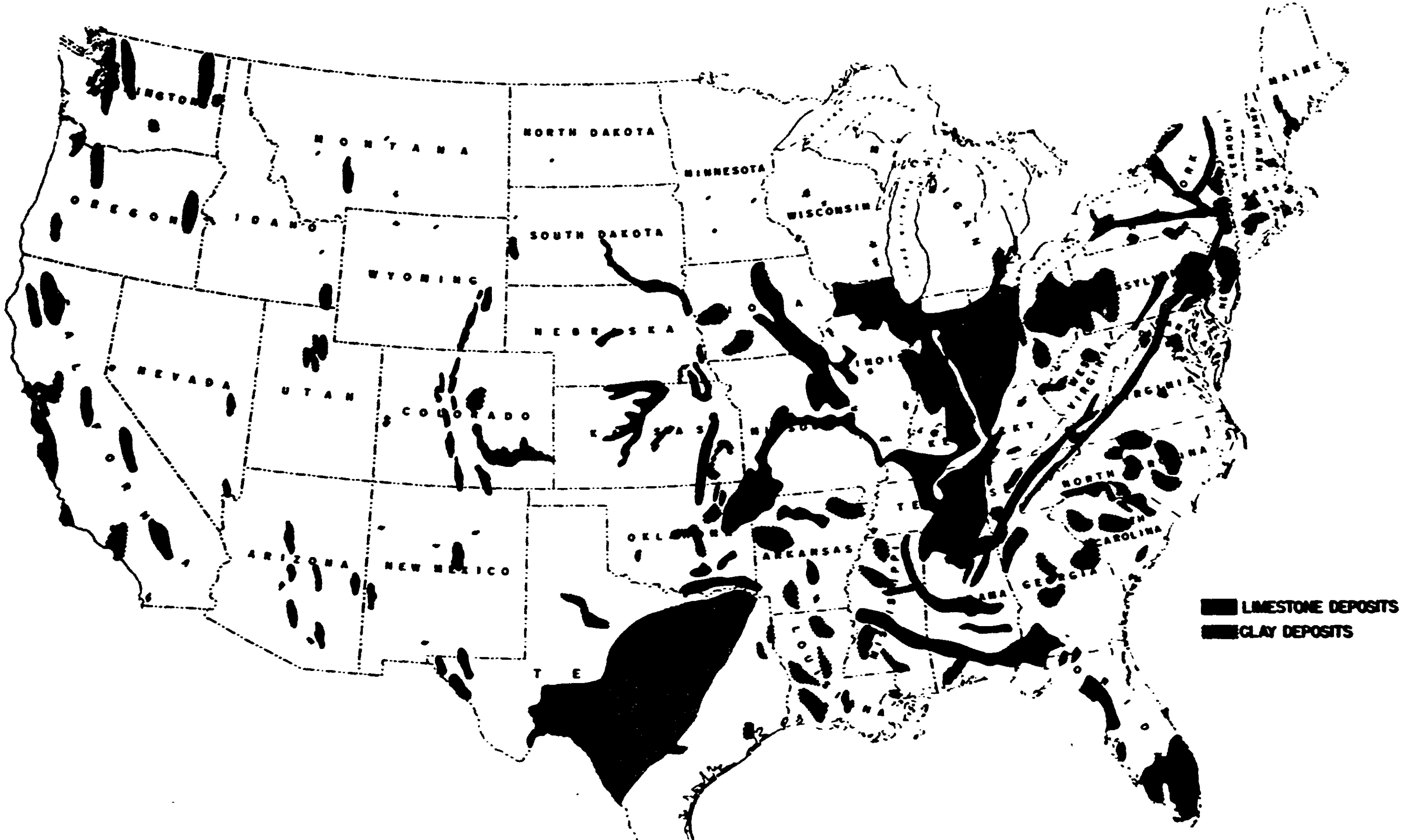
how clay is formed

5034


.... how glaciers fed
North American river systems,
creating clay deposits

5035

LOCATION OF KNOWN U.S. LIMESTONE & BRICK AND TILE CLAY DEPOSITS



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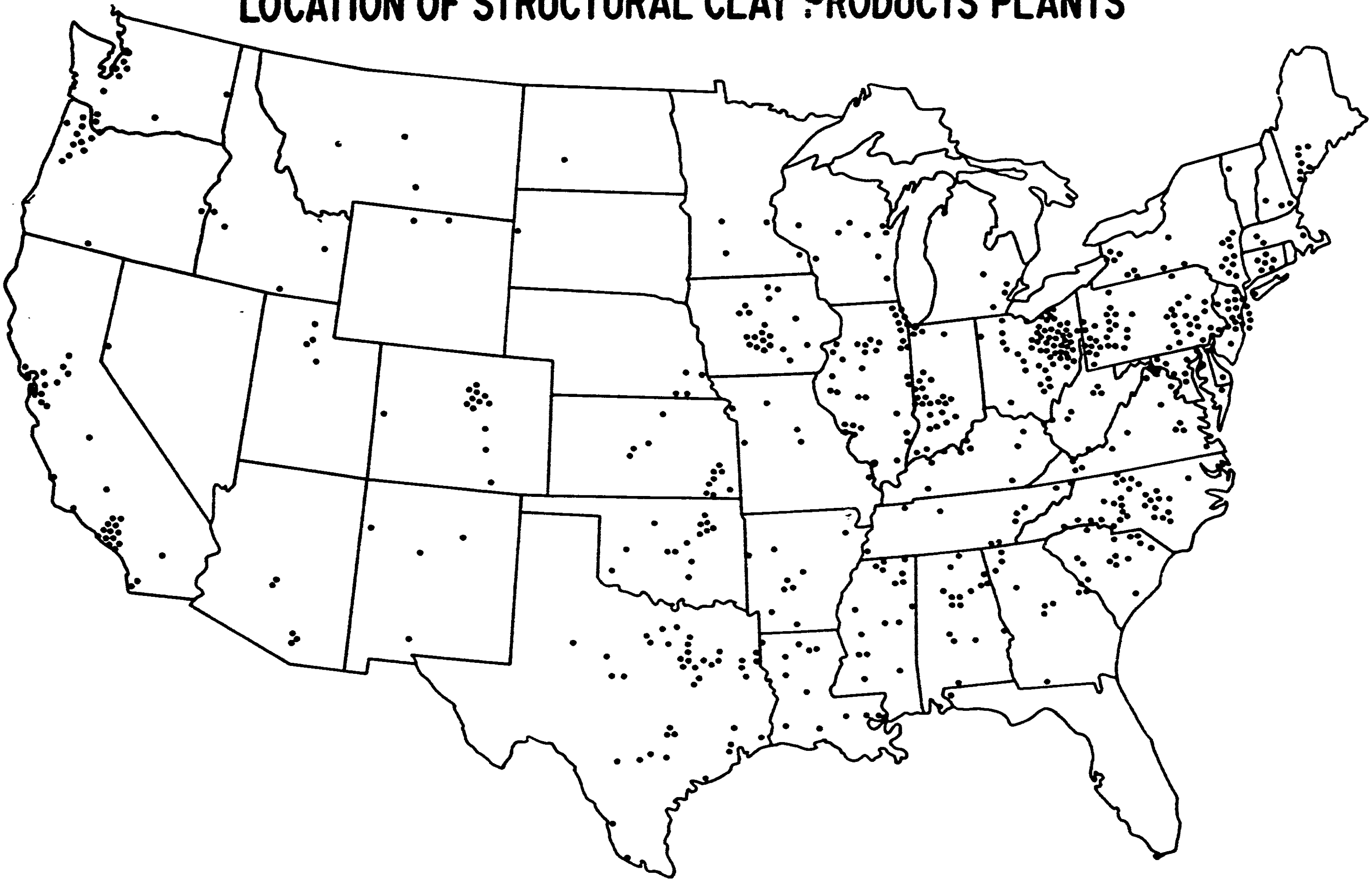
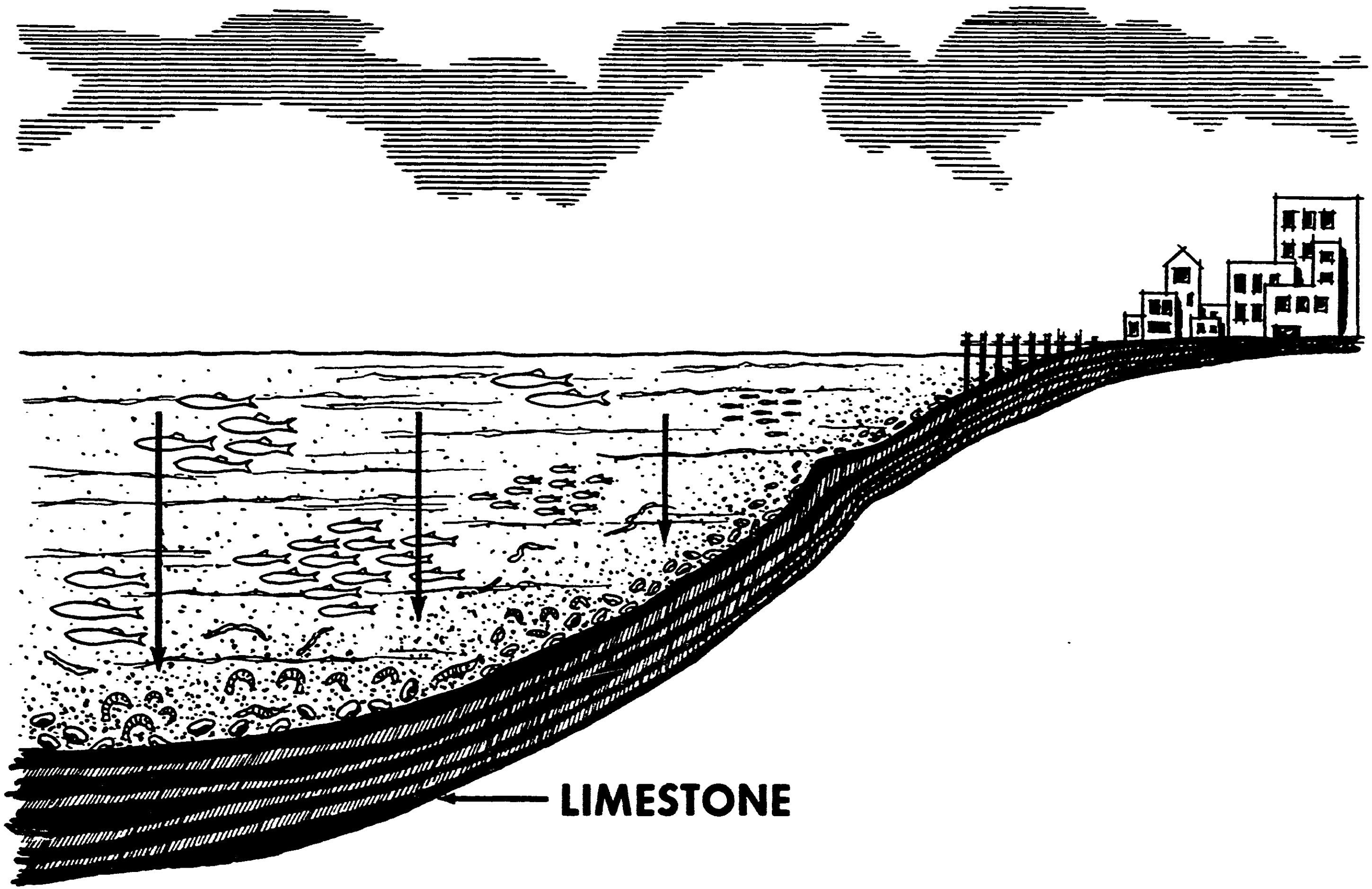
LOCATION OF STRUCTURAL CLAY PRODUCTS PLANTS

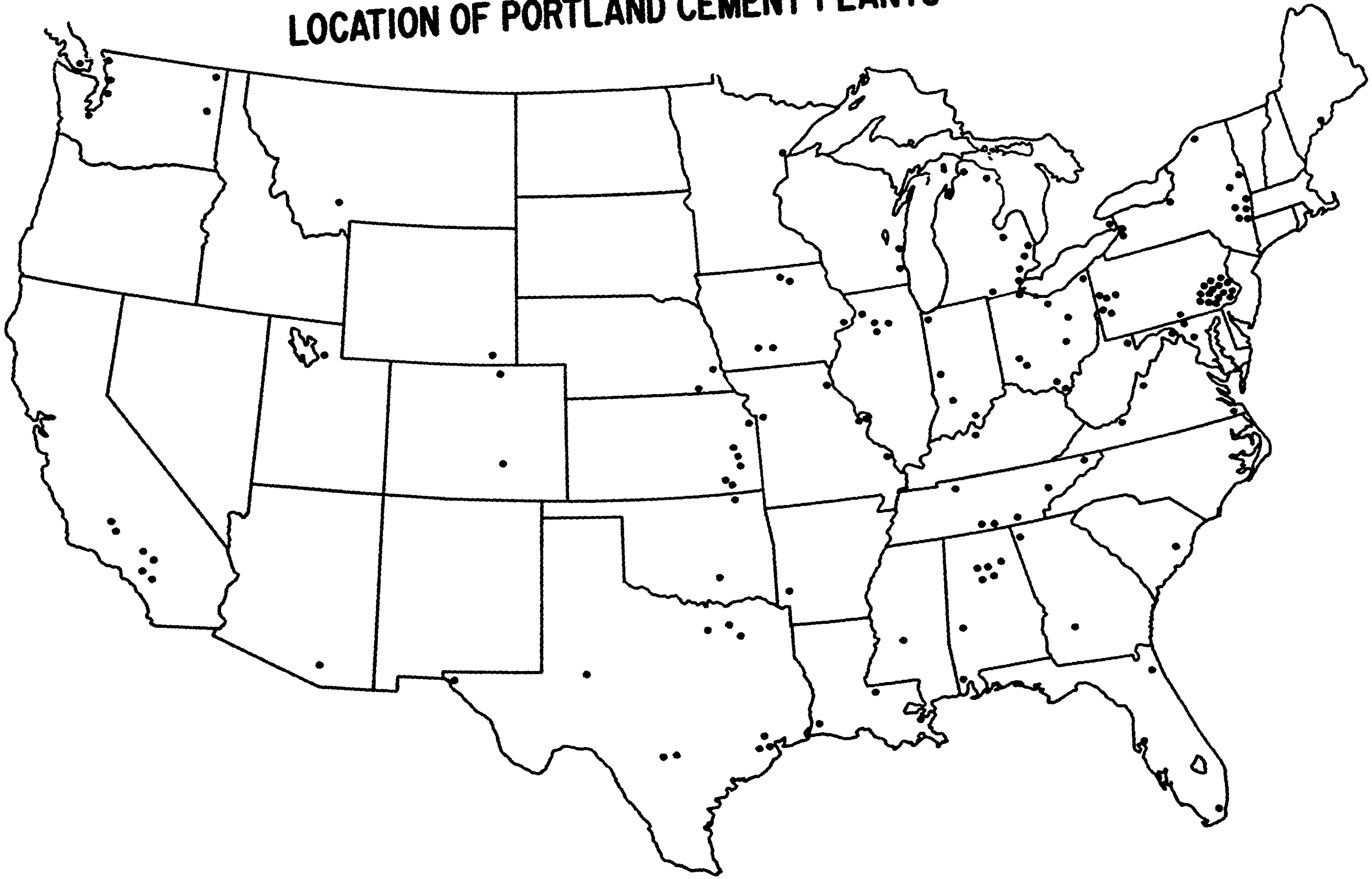


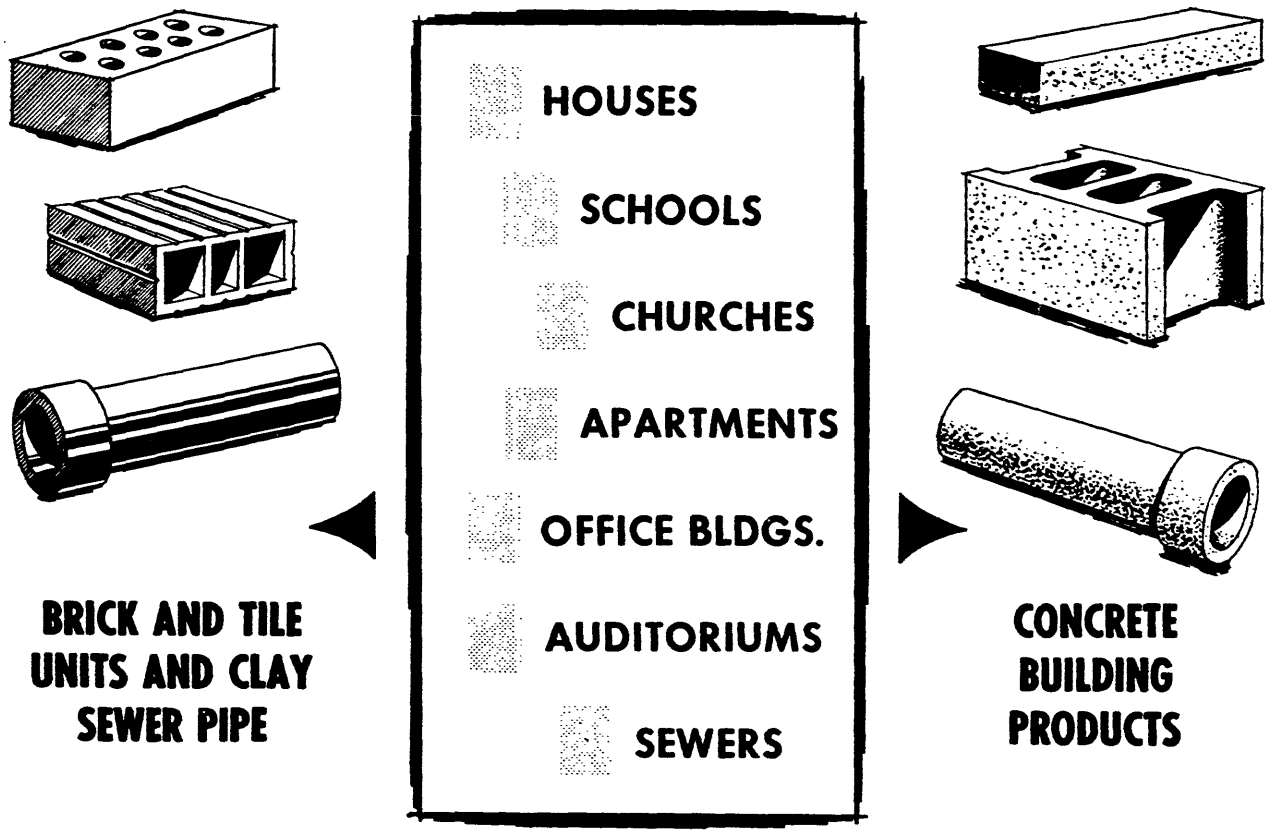


how limestone is formed

5038

LOCATION OF PORTLAND CEMENT PLANTS





direct competition of structural clay products and concrete products in every building market

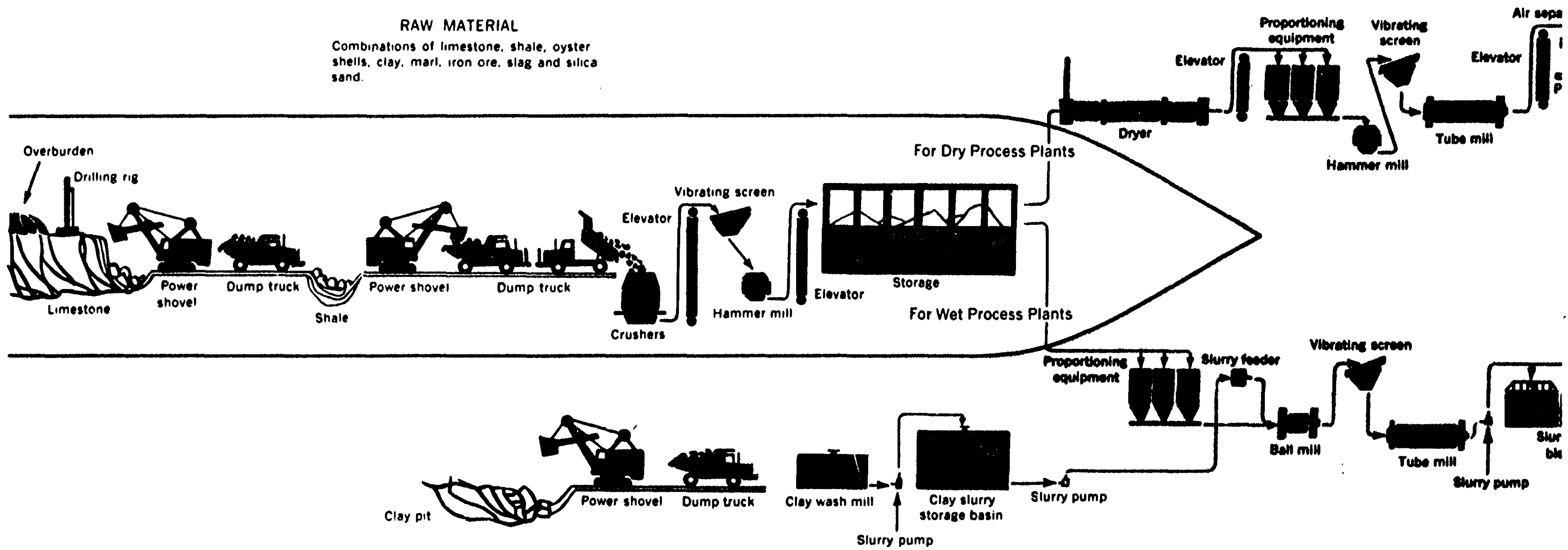
5040

33-885 O - 69 pt. 5 (Face p. 5040)

MANUFACTURE OF PORTLAND CEMENT

RAW MATERIAL

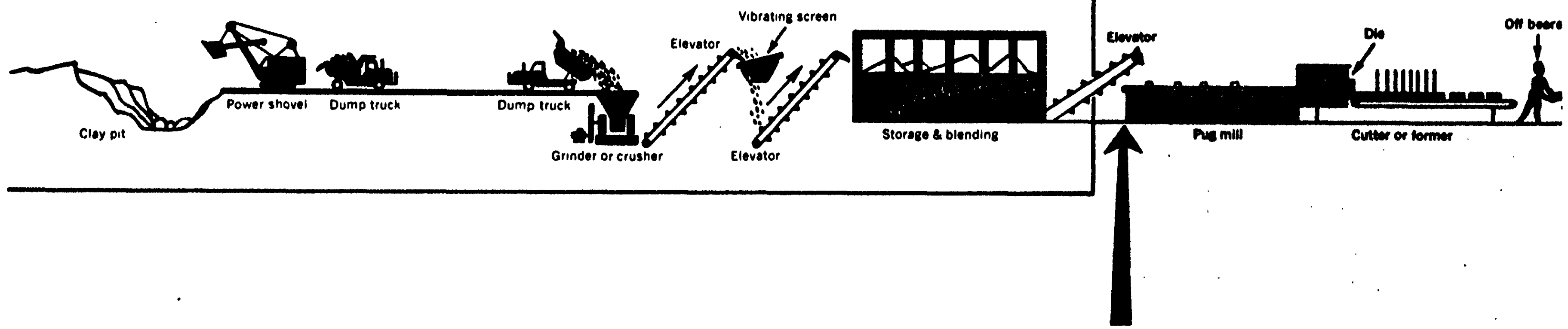
Combinations of limestone, shale, oyster shells, clay, marl, iron ore, slag and silica sand.



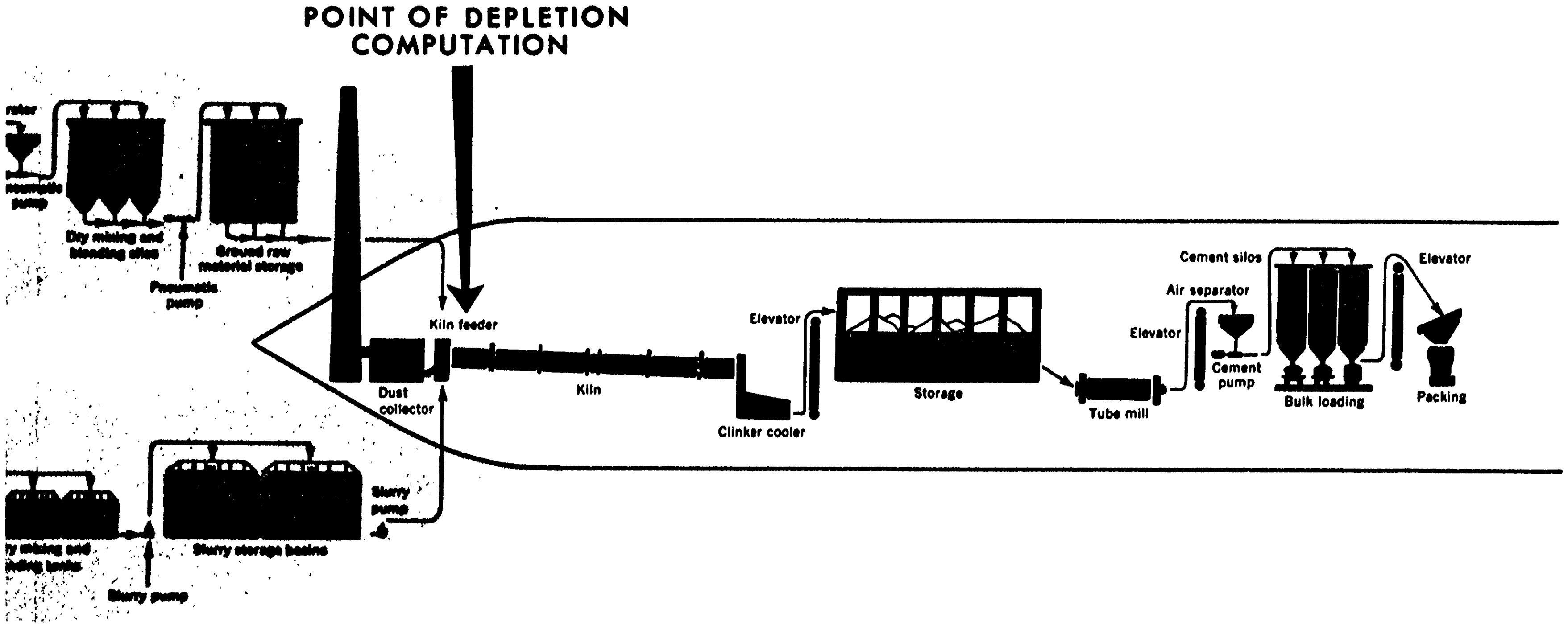
MANUFACTURE OF BRICK, TILE OR SEWER PIPE

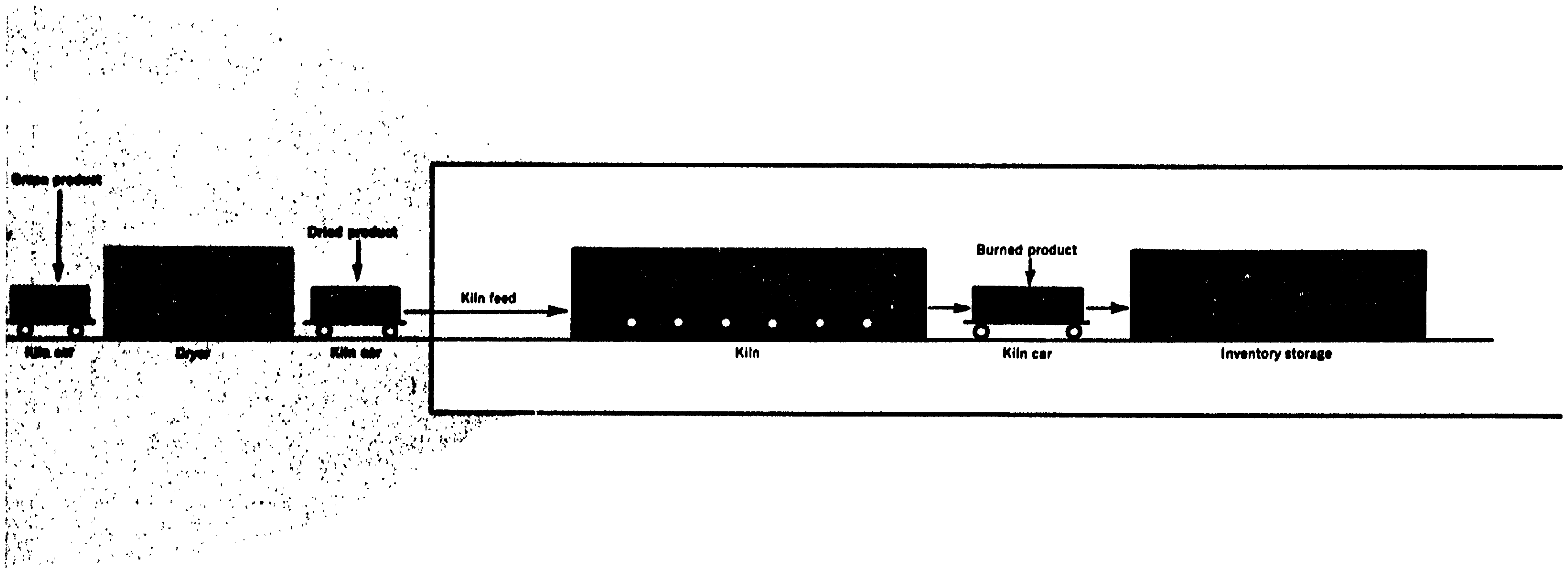
RAW MATERIAL

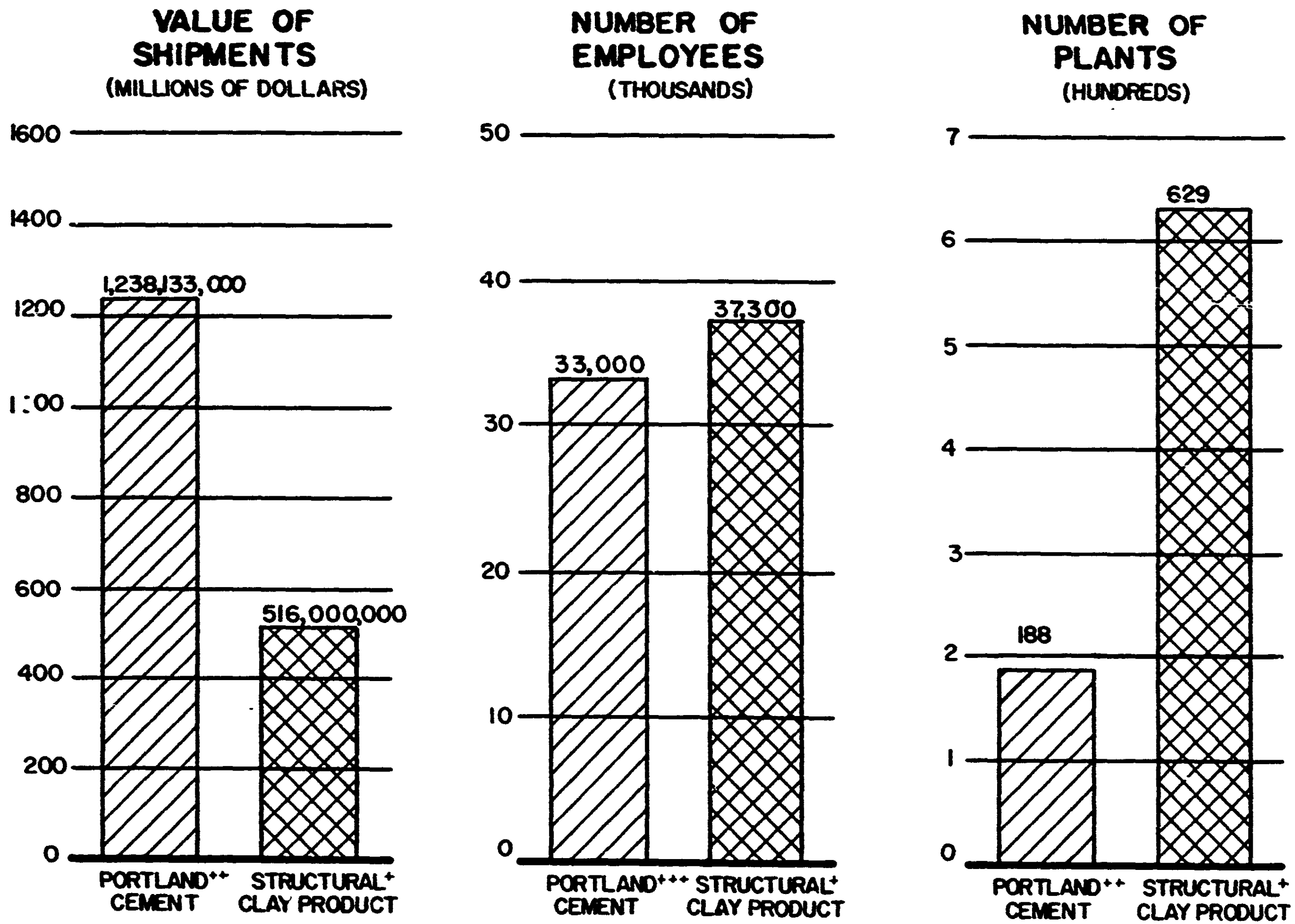
Brick & tile clay—fire clay—shale.



POINT OF DEPLETION COMPUTATION


POINT OF DEPLETION COMPUTATION
Dry mixing and blending silos
Ground raw material storage
Pneumatic pump
Kiln feeder
Dust collector
Kiln
Elevator
Clinker cooler
Storage
Tube mill
Elevator
Air separator
Cement pump
Cement silos
Bulk loading
Elevator
Packing
Slurry storage basins
Slurry pump
Slurry pump


Dried product
Kiln feed
Kiln
Burned product
Kiln car
Inventory storage



\+ DATA SUPPLIED BY U.S. DEPT. OF COMMERCE 1967

++ DATA SUPPLIED BY U.S. BUREAU OF MINES

+++ ESTIMATE BASED ON U.S. DEPT. OF COMMERCE 1964-66

FREEPORT SULPHUR CO.,
New York, N.Y., October 7, 1969.

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

DEAR SENATOR LONG: As Chairman of the Board of Freeport Sulphur Company, I wish to make known to you our objections to the provisions of H.R. 13270, the tax bill passed by the House and now under consideration of your Committee, which would adversely affect the present income tax treatment of sulphur and other minerals.

The wisdom of maintaining the existing law has been demonstrated. Discovery of sulphur reserves and development of productive capacity, achieved at great expense and great risk, are evidence that the allowance has accomplished precisely what Congress intended. Similarly—in oil and gas, in nickel, copper, and other minerals—tax provisions have encouraged Freeport and other companies to take risks in both foreign and domestic exploration and development which would otherwise have been too great to assume.

We are convinced that nothing should be done to reduce the incentive to take such risks. We are convinced that it is in the interests of the nation and of the public that the depletion allowance and the foreign tax credit continue to spur the search for sulphur and other vitally needed minerals.

For the above reasons which are set forth in detail in the attached statement, Freeport Sulphur Company respectfully requests that your Committee reject Section 501(a), Section 431, and Section 432 of H.R. 13270, and any other proposals which would have the effect of reducing the mining industry's present incentives to find and develop mineral reserves.

Respectfully,

THOMAS R. VAUGHAN.

Attachment.

STATEMENT OF FREEPORT SULPHUR CO. IN OPPOSITION TO THE PROVISIONS OF H.R. 13270 AND TO TREASURY DEPARTMENT PROPOSALS THAT WOULD ADVERSELY AFFECT THE U.S. MINING INDUSTRY

Freeport Sulphur Company operates sulphur mines located in and off the coast of Louisiana. Freeport also mines china clay (kaolin) in Georgia, potash in New Mexico, and phosphate rock in Florida; and we produce oil in Louisiana, Kansas, New Mexico, Oklahoma, and Texas. At the present time our company is actively investigating the feasibility of mining a copper deposit in Indonesia, nickel deposits in Australia, and asbestos n Mexico. We own a large deposit of pyrrhotite in Virginia, which we hope in time to develop, and we are exploring for oil and various minerals in other states and elsewhere in the world. In addition to our mining and oil activities, we own and operate a large phosphoric acid plant in Louisiana.

For the reasons discussed below, Freeport believes that Congress should reject so-called tax reform proposals which would add heavily to the weight of the tax burden on the natural resource industries. Specifically, we respectfully urge that your Committee reject Section 501(a), Section 431 and Section 432 of H.R. 13270. In support of our position we present the following.

I. WHY PERCENTAGE DEPLETION RATES SHOULD BE RETAINED AT THEIR PRESENT LEVELS

Section 501(a)

The depletion allowance recognizes that production of minerals such as sulphur, is distinctly different from, say, manufacturing. Mineral production involves *constant sale of capital assets.* While a manufacturing firm can produce indefinitely with a constant flow of raw materials, a mining company cannot replenish a mineral deposit when that deposit becomes exhausted. Every mining company, by its very nature, is constantly mining itself out of business.

A mining company's only recourse is to find new properties, new reserves. This is a formidable and financially risky job, because the odds against the explorer are very great and the odds against successful development of a find may be greater still. Where, as in the mining business, failures far outnumber successes, the rewards of success must be great enough to underwrite the inevitable losses which have gone before and will come after, if exploration and development are to continue.

We submit that encouragement of mineral exploration and development was never more important than it is now. The Bureau of Mines is predicting that United States minerals demand will increase by more than four times by the year 2000, whereas domestc mineral production projected on the basis of 20-year trends can be expected to do little more than double by 2000 A.D. Furthermore, the Bureau of Mines is predicting a five-fold increase in worldwide demand for minerals by the end of the century.

Thus we are faced with a widening gap between domestic mineral supply and domestic mineral consumption. The problem of obtaining adequate supplies from foreign sources is complicated by an even more rapid increase in foregn demand for minerals. Such a situation clearly calls for increasing—and not dampening—mineral-exploration incentives.

A. Sulphur

H.R. 13270 would reduce the percentage depletion rate for sulphur from 23% to 17%. Sulphur, a basic element, is an important commodity to our economy. Almost everything we eat, wear or use requires the use of sulphur in some stage of its preparation.

Sulphur exists in many forms and is produced in 55 countries. More than one half of the sulphur being produced and consumed in the Free World is in the form of elemental sulphur or brimstone. The largest domestic sources of brimstone are the salt dome type deposits located in the Gulf Coast area, which are mined by the Frasch hot-water process. Only one in 13 of the domes so far discovered in the United States has been found to contain sulphur in commercial quantities. Of the 348 discovered domes, only 26 have produced sulphur commercially, and nine of these have been exhausted.

Freeport is one of many companies which have incurred great risks and expense to prospect domes which in the end proved to be worthless. Because nearly all of the land-area salt domes in the Gulf Coast region have been explored, we and others have turned in recent times to the open Gulf of Mexico where the search is far more costly. Freeport paid the Federal Government $12,000,000 for the right to explore for sulphur at several locations beneath the Gulf of Mexico off the coast of Texas and then spent another $3,000,000 in exploratory drilling at the locations during 1966 and 1967 and found nothing. At the same time other companies spent more than $20,000,000 in the same general offshore area and found nothing.

By 1980, it has been projected, United States consumption of brimstone will exceed United States production by 100%. From this fact alone it is clear that sulphur producers should be encouraged to explore for additional reserves. Obviously, any reduction in the incentive that U.S. companies now have would seriously jeopardize our long-term national interest and security.

B. China clay (kaolin)

China clay is a scarce type of clay having many important industrial uses in producing paper, rubber, porcelain, whiteware, and paint. The domestic industry is small, and the great bulk of the production comes from rural areas in Georgia and South Carolina.

China clay is presently allowed a 15% rate of percentage depletion, but H.R. 13270 would reduce that rate to 11%. Any reduction, we submit, would harm a small industry and a rural area of the country without any significant increase in revenue. The proposed cut in rate to 11% would produce less than $1,000,000 of additional revenue from all of the U.S. producers combined. This amount, although not substantial from the Treasury's revenue standpoint, is significant from the china clay industry's viewpoint. To the extent that the amount could not be passed on to the consumer, this increase in cost (together with other rapidly accelerating costs) would require a serious reduction in research and development, and reduce the producers' return on investment to such an extent that additional capital may not be available for industry growth. To the extent that the additional tax could be passed on, the resulting increase in prices would adversely affect not only our domestic economy but also our balance of payments, since the major foreign producer (almost as large as all the U.S. producers combined), is ready, willing, and able to increase greatly its sales in the U.S. markets.

C. Other minerals

Freeport, in order to replenish its mineral reserves and to maintain itself as a going mining concern, is engaged in a worldwide search. The finding and development of such reserves not only keeps Freeport alive as a company but is necessary to supply the rapidly increasing demand for minerals of every kind.

Freeport is currently studying the feasibility of developing a copper deposit in West Irian (Indonesia) which will require a very large investment. The importance of this activity is demonstrated by present estimates that Free World demand for copper will more than double in the next 20 years. While the United States leads the world in both production and consumption of copper, the extent to which it meets its future requirements from domestic sources is likely to decrease. Imports will have to supply an increased percentage of future United States demand for this key commodity. The proposed changes in H.R. 13270 relating to percentage depletion and foreign tax credit would substantially increase the cost of projects such as Freeport's Indonesian project. Exploration of this property was the first foreign investment project authorized by the Indonesian Government following the overthrow of the Sukarno regime in 1965; it is important to our country's relations with the Indonesian government.

The commercial development of this deposit requires the solution of formidable problems. The deposit lies on the face of the Ertsberg (a Dutch name meaning ore mountain), a primitive area in the forbidding Carstensz Mountains in West Irian, at an elevation of 11,500 feet above sea level and 60 miles inland from the southern coast. The 60 miles of terrain which lie between our base camp on the coast, with its tropical climate, and the site of the deposit, with frequent subfreezing temperatures, is exceedingly rugged. The first part consists of estuaries and mangrove swamps, followed then by coastal plain and jungle, and finally by a jagged mountain range. Equipment and supplies for the exploration had to be flown to the site by helicopters brought from the United States.

In Australia, Freeport is investigating the feasibility of mining nickel from the Greenvale deposit discovered in Queensland, and is preparing to develop a second nickel deposit, discovered at Nepean in Western Australia.

Since it seems unlikely that the United States will ever obtain much of its primary nickel from domestic sources, Freeport's nickel activities are important to our country. Foreign resources are available only if extraction of nickel from low-grade deposits can be accomplished at realistic costs. Any increase in costs of a U.S. company due to changes in depletion and the foreign tax credit would discourage exploration and development of such prospects. Since foreign producers can avail themselves of tax incentives afforded by their governments, which recognize the significance of minerals to their respective economies, the proposed changes in H.R. 13270 would worsen the competitive position of United States producers.

Another provision of H.R. 13270 would eliminate entirely the percentage depletion deduction in the case of foreign oil and gas deposits. We concur with the Treasury's position made before your Committee on September 4 to the effect that "this provision (should) be deleted from the bill" since "the elimination of percentage depletion on foreign deposits of oil and gas is unlikely to increase U.S. revenues significantly, and will merely increase the burden of foreign taxes on U.S. businesses."

We urge rejection of Section 501(a).

II. WHY THE PROPOSED CHANGES IN THE COMPUTATION OF THE FOREIGN TAX CREDIT SHOULD BE REJECTED

As domestic sources of vital minerals shrink, foreign exploration and development becomes increasingly significant.

Since 1918 the United States has allowed a credit against the U.S. tax liability on foreign-source income for income taxes paid to foreign governments on such income. The purpose of this credit is to achieve equality of treatment between taxpayers and to prevent international double taxation. Many countries (for example, the United Kingdom, France and The Netherlands) prevent international double taxation simply by not taxing foreign income of their citizens which has already been subjected to foreign income taxes. The number of tax treaties in which the United States and other countries are parties attest to the widespread insistence that double taxation be avoided.

Section 431

Where a U.S. taxpayer uses the per country basis in determining its foreign tax credit, Section 431, contrary to existing law, would not in every instance allow a full credit for foreign income taxes paid. Specifically this Section, by means of a complicated formula, would require a taxpayer who reduces his U.S. tax on U.S. source income by reason of a loss from operations in a foreign country to pay back this benefit when income is later derived from that country regardless of whether or not foreign taxes are actually paid on this income. This proposed requirement would result in many instances in subjecting foreign source income to double taxation and would therefore substantially restrict the effectiveness of the foreign tax credit as a means of eliminating the double taxation of income, thus unfairly increasing the tax burden on U.S. companies and making them less able to meet foreign competition.

We urge rejection of Section 431.

Section 432

This section would introduce a special limitation on the amount of credits allowed for foreign income taxes paid in connection with foreign mineral producing activities in situations where the foreign income taxes paid are deemed to be royalties.

We believe the tests proposed to determine when foreign income taxes are to be deemed to be royalty payments are artificial and inequitable.

We support the statement presented before your Committee on September 4 by Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy:

> "If, then, this separate limitation in the bill regarding mineral income is not justified on the ground that any foreign tax in excess of the effective U.S. tax on mineral income is a royalty, it works unfairly for mineral companies as compared to all other U.S. taxpayers with foreign operations. It completely denies mineral companies the opportunity, available to other taxpayers, to average the excess of foreign tax over U.S. tax on mineral income against any excess of U.S. tax over foreign tax on their other foreign income."

We urge rejection of Section 432.

As an alternative to Section 432, the Treasury Department proposes that companies be denied the use against non-mineral income of excess foreign tax credits created by the U.S. percentage depletion deduction on foreign mineral income.

This complex proposal would arbitrarily increase tax burdens on foreign mineral income under the assumption that there is some special problem in current laws covering the taxation of such income. We believe this assumption to be erroneous.

We urge rejection of this proposal.

Finally, in connection with Sections 431 and 432, it would in any event appear wise to postpone action in view of the Treasury Department's statement before your Committee on September 4:

> "We plan to present recommendations to Congress on this subject as a part of comprehensive proposals relating to the taxation of foreign source income which we are presently developing. . . ."

III. CONCLUSION

The real beneficiaries of mineral tax laws have been the American people, who have seen an increasing supply of basic materials and energy sources at reasonable prices. Our standard of living is higher than that of any other nation, and we have the highest per capita production and consumption of minerals of any country in the world.

The wisdom of maintaining the existing law has been demonstrated. Discovery of sulphur reserves and development of productive capacity achieved at great expense and great risk, are evidence that the allowance has accomplished precisely what Congress intended. Similarly—in oil and gas, in nickel, copper, and other minerals—tax provisions have encouraged Freeport and other companies to take risks in both foreign and domestic exploration and development which may otherwise have been too great to assume.

We are convinced that nothing should be done to reduce the incentive to take such risks. We are convinced that it is in the interests of the nation and of the public that the depletion allowance and the foreign tax credit continue to spur the search for sulphur and other vitally needed minerals.

For the reasons set forth above, Freeport Sulphur Company respectfully requests that your Committee reject Section 501(a), Section 431, and Section 432 of H.R. 13270.

LONGVIEW, TEX., *September 22, 1969.*

Re Tax Reform Bill.

DEAR SENATOR YARBOROUGH: Regarding the Tax Reform bill that was passed by the House of Representatives, which reduced the Oil & Gas Depletion Allowance and of which certain Senators also are now advocating a large cut; I would appreciate it very much if you would ask these certain Senators "Just who is going to find new reserves and operate the industry in the future, if the incentives are taken away from the highest risk business in this country?".

Our country must have large reserves of Oil & Gas for its future energy needs and for any defense emergency that may come, but if the incentives like the Depletion Allowance and intangible drilling expenses are taken away, young men starting to college will have no interest in studying Geology, and/or Oil Engineering. Losing them out of this field of business will be a loss to the country, and more especially to the Independent Producer. All these crys of "Cut the Depletion Allowance," "Import More Foreign Oil", "Lower the Price of Crude Oil", dampens the interest in this field for our young students. If you will check the records of the various Universities you will find that the number of students who are taking courses pertaining to oil and gas is about 50% of what the number was 10 years ago, and yet our energy needs in the future are going to be greater than in the past, so that we will be needing more, not less, Geologist and Engineers.

Ours is a big risk business, and I am a good illustration of that, during the past two years I have participated in the drilling of 37 dry holes on wildcat blocks of acreage. It takes money to wildcat and find oil, and many times the Independent has to borrow to run this risk in drilling and to do business; so there must be a fair incentive for a young Independent to take this risk. Let's not take that chance away from him by removing all incentives.

We must find more reserves of oil and gas in the 48 states, as we cannot always depend on foreign crude oil—nor can we even depend on the new Alaskan reserves, as they are highly vulnerable to military attacks both at the production site and in transit.

I realize a few men, in the past, made gigantic fortunes in the oil business, but most of these fortunes were made when drilling was shallow; labor and supplies were comparatively cheap. Its a new day now, drilling is deeper and costs are way up.

For the future, and the good of our country, I hope that reason will prevail and that our future energy requirements will not be jeopardized by persons who have not really studied all the facets in the finding a barrel of crude oil.

Kindest regards,

Sincerely,

JOE MUCHER.

STATEMENT SUBMITTED BY MOBIL CORP., NEW YORK, N.Y.

A. I. CRITERIA FOR TAX REFORM

For tax reform to be tax improvement it should meet certain constructive criteria.

In his message of April 21, accompanying his original tax reform proposals, President Nixon set out a number of such criteria.

In the next few paragraphs we restate President Nixon's tax reform criteria and give the reasons why we think that HR 13270 and the Treasury suggestions of September 4, 1969 do not measure up to these standards.

1. *"The American people need and deserve a simplified federal tax system."*—HR 13270 has 367 printed pages of legislation which, as one member of the Ways and Means Committee stated, will add another 20% to the bulk of the Internal Revenue Code.

The Bill has already been characterized as "the Lawyers and Accountants Relief Act of 1969."

It introduces a wide new variety of complexities and administrative burdens to the tax law without the benefit of adequate hearings on the specific proposals. The usual Treasury staff study did not take place with respect to many of the provisions and the necessary and useful reviews by the appropriate committees of bar and accounting associations have not yet occurred in the normal manner.

The complex approach and the rapid timetable that has been adopted have produced many inconsistencies, gaps, and probably unintended results. We comment on these in connection with sections 431, 432 and 501 in Part B. Similar problems exist in many of the other sections. The section relating to deferred compensation is a case in point of added complexity. The taxation of "deferred compensation" at rates other than those applicable in the year of receipt will require annual recomputation of taxable incomes for 10, 20 or 30 back years by persons who receive compensation on a deferred basis.

2. *A program of tax reform should be developed within the limits of fiscal responsibility. We should "repeal the tax of inflation", "a cruel and unjust tax."*—The House Bill, especially after the Ways and Means Committee corrected a "2.4 billion misunderstanding," creates hope for relief among millions that may have to be paid for with inflation. Inflation should be brought under control before new deficits are generated by reductions in government revenues. Until we have achieved more stable economic growth, it seems a mistake to enact nominal tax relief that can only complicate the government's ability to achieve a balanced program of fiscal responsibility.

3. *Tax Policy should be equitable; it should not "soak" any group or give a "break" to any other.*—The revenue raising aspects of the bill are intended to increase annual revenues by $6.9 billion after all the reforms have been phased in. Practically all of it will come from corporations. We respectfully suggest that the result is: "soak" the corporations.

Among corporations, the oil industry is particularly "soaked" by changes raising its taxes: Depletion reduction and elimination; foreign tax credit reduction and production payment elimination would have to be borne in addition to the taxes resulting from the revenue raising measures (such as repeal of investment credit and the cutback in certain depreciation) applicable to corporations in general.

Among individuals, investors in oil and gas operations are subjected to significant tax increases. Furthermore, professionals and the salaried corporate management group are especially hard hit by the cumulative impact of the following: increase in capital gain holding period; elimination of capital gains alternative 25% tax; reduction of capital gains treatment of lump sum distributions from qualified pension and profit sharing plans; disallowance of interest on certain invested borrowings; allocation of deductions; elimination of restricted stock; and substantial elimination of deferred compensation.

4. *Tax Policy should carefully distinguish between tax preferences that provide "social benefit" and "should be expanded" and those that are "inefficient or subject to abuse" and "should be ended".*—In the House Bill tax preferences have in many cases been viewed as evil per se and their incentive aspects not adequately considered. Examples: capital gains rates are increased and the holding period is lengthened (even if the gain is due largely to inflation); the deduction for charitable contributions of appreciated property is substantially reduced; accelerated depreciation on buildings, including new and rehabilitated housing, is subject to recapture; interest on state and local bonds is subjected to tax.

The massive attack on the preferences applicable to oil and gas—motivated by "symbolism"—is especially unfortunate. Some of the most significant changes enacted by the House—those involving percentage depletion and foreign operations—were not recommended by either the Nixon or the Johnson Administrations. As recognized in the studies and proposals for tax reform developed by the Treasury Department during the Administration of President Johnson:

> "The tax treatment of this industry, however, is only one aspect of many relating to our energy industries and therefore bears a relationship to our overall energy policies. These policies are of importance to national security, our balance of payments, foreign trade, and other important areas of public concern in addition to tax fairness."

President Nixon has assumed personal responsibility for the oil imports program and has commissioned a comprehensive review of the entire problem. The decision as to whether the provisions relating to oil and gas are "inefficient or subject to abuse" and should be ended *or* provide necessary "social benefit" and "should be expanded" should be made with reference to our overall policies as to petroleum needs and national security, and ought not to be taken until the President has had the opportunity to reach a decision based on that study and to communicate his balanced evaluation to the Congress.

5. *Good tax reform requires that we "thoroughly review the entire Federal Tax system" and consider "recommendations for basic changes, along with full analysis of the impact of those changes".*—The single most frequent criticism of 1969 tax reform action to date is that it has been done too hastily. We have not had a thorough review of the entire Federal tax system. The Ways and Means Committee wisely deferred consideration of the estate and gift tax provisions of the Code. The Treasury has appropriately stated that the deferred compensation provisions require more study. The same deliberate approach should be adopted in other cases—especially the provisions relating to oil and gas.

Hasty action—and some members of the Ways and Means Committee stated that haste in July made it impossible for them to fully analyze the impact of the changes included in H.R. 13270—is not likely to lead to lasting tax reform. Drafting of provisions affecting the oil and gas industry can only suffer if it must be done before the results of the President's review of imports and the Treasury's study of the provisions regarding taxation of foreign income are available. Repeal of the investment tax credit is premature while the President's newly appointed committee is considering the impact of taxes on business. While all desire tax reform now we respectfully suggest that sound tax reform requires the opportunity to fully analyze the impact of the changes being considered. If too short a timetable is set it will be difficult to avoid having sound economics overwhelmed by political symbolism.

A. II. H.R. 13270 IS ANTI-OIL. THE TREASURY SUGGESTIONS OF SEPTEMBER 4 PROVIDE SOME IMPROVEMENTS IN CERTAIN AREAS BUT ARE WORSE IN OTHERS

A. Termination of investment tax credit

Section 703 would terminate the investment tax credit. The investment tax credit termination would affect all business and not merely the oil industry. Its weight would, however, bear particularly hard on capital intensive industries of which the oil business is a prime example. The effective date provisions bear heavily on all industry—especially industries such as oil that have long lead times in their capital investment programs. The investment tax credit was enacted as a permanent part of our revenue system. It has served its purpose to assure the modernization and competitiveness of U.S. industry. Its long term effect is anti-inflationary. In the short term termination will produce confusion; it will not aid the short term fight against inflation.

B. U.S. percentage depletion reduced to 20% (discussed in detail in part B)

Sec. 501 would reduce the allowable rate of percentage depletion on U.S. oil and gas wells to 20%. This would have an adverse effect on the U.S. oil and gas industry that would be serious—far more serious than is suggested by the "CONSAD Report". Such a cut would require an increase in gasoline prices or it would result in an appreciably lower flow of capital into the business. The Treasury did not propose a cut and in his recent press conference the President reaffirmed that he believes it would be unwise to reduce the rate. We strongly urge that the reduction should not be enacted.

C. Foreign percentage depletion eliminated (discussed in detail in part B)

Sec. 501 would eliminate percentage depletion of foreign oil and gas wells. Sec. 501 would treat foreign oil and gas in the same category as air, dirt, seawater and other inexhaustible sources. Every other mineral that is granted percentage depletion in the U.S. is also entitled to the deduction abroad. Most of the important minerals—as in the case with oil and gas today—are entitled to use the same rate at home and abroad. The Treasury has recommended that the rate for foreign depletion be the same as domestic; we strongly support the Treasury position.

D. Production payment financing. (Discussed in detail in part B)

Sec. 501 would treat the sale of production payments as a loan regardless of fact that the sale is recognized as such under applicable state law. This change will unwisely eliminate the utility of such sales as a source of capital for oil operations.

E. Foreign tax credit. (Discussed in detail in part B)

Sec. 431 provides for the recapture of foreign losses through a complicated limitation on future allowable foreign tax credits. As proposed it would operate unevenly and we believe illogically. The major difficulty of the proposal however is that it is an oblique attack on the expensing of intangible drilling expenses by companies doing business abroad. The restriction of this incentive raises serious policy questions. No such change should be made at least until there has been a careful consideration of our overseas petroleum policy objectives.

Sec. 432 would limit the use of surplus foreign tax credits arising from foreign mineral activities (narrowly defined). The reason given by the Ways and Means Committee for the provision was the difficulty of distinguishing between foreign income taxes and other payments such as royalties. The Treasury recommends elimination of Sec. 432, pointing out that normal royalties are paid overseas as they are in the U.S. We concur in the Treasury's recommendation.

The Treasury, however, in lieu of the House proposal, has suggested that surplus foreign tax credits arising as a result of the percentage depletion deduction be restricted.

The Treasury has also suggested that consideration be given to a further restriction in cases in which the effective foreign income tax rate is greater than 60%. The Treasury also announced that it is conducting a comprehensive review of the taxation of foreign income.

We believe that the foreign tax credit should apply uniformly to all taxpayers and that there should be no special discriminatory provisions applicable to mineral activities. We oppose enactment of Secs. 431 and 432.

In any event no changes in the foreign tax credit provisions should be made pending the review that Treasury has undertaken.

F. LTP and allocation of deductions

Secs. 301 and 302 provide for a limitation on tax incentives currently granted to individuals. Among the incentives to be limited are intangible drilling expenses and percentage depletion. The Treasury has recommended that these provisions should apply more onerously against oil and gas investments than has been provided in HR 13270. The underlying concept of the limitation provisions is questionable and there does not seem to be a persuasive rationale why oil and gas investments should be treated more severely than other worthwhile investments such as municipal bonds.

On September 4 the Treasury also proposed that in certain undefined circumstances intangible drilling expenses that had been deducted would be "recaptured"—i.e. restored to income at ordinary rates—when the property is sold. While it appears that this provision would be limited to certain situations that would have been covered by the LTP provisions but for a Treasury proposed 60% rule—it is not clear that it is so limited (no statutory language was proposed). Even if it is so limited it seems unfair, and where applicable, could be a greater burden than the relief from LTP originally granted under the Treasury proposal.

G. Gasoline tax deduction (September 4 Treasury proposal)

The Treasury proposed on September 4 to increase income taxes on gasoline users who itemize their deductions and thus currently claim the present allowable deduction for state gasoline taxes. For a state that charges a 6¢ gasoline tax, this would result in an increase in the after tax cost of gasoline from 1¢ to 4¢ per gallon, depending upon the consumer's marginal income tax rate. This proposal would pyramid a large new gasoline cost on top of the predictable increases that the remainder of the proposed legislation would force.

In sum HR 13270 and the Treasury message of September 4 are anti-oil in general and in their specifics. No other sector of the economy is singled out for such heavy new cumulative burdens. In the next section we discuss why such action would be specially inappropriate at this time.

A. III. ANTI-OIL CHANGES IN THE TAX LAW SHOULD NOT BE ENACTED WITHOUT FULL ANALYSIS OF THE CONSEQUENCES. CHANGES SHOULD BE MEASURED AGAINST U.S. NATIONAL PETROLEUM OBJECTIVES

It is inappropriate to enact anti-oil changes because:

(a) The President is in the process of formulating national petroleum objectives as a necessary part of the Presidential Imports Study.

(b) The facts will show that the U.S. owned oil industry needs to attract more capital in the future than it has in recent years.

(c) Existing incentives and regulations (including those relating to U.S. gas) have produced an industry that:

(1) earns no more than a fair return on capital measured against other industries;

(2) charges prices that have increased less than other prices;

(3) pays a fair share of tax when appropriate account is taken of state and foreign taxes;

(4) has just been able to maintain the level of U.S. reserves (thus resulting in declining reserve/production ratios and a rapidity approaching gas shortage).

It is inappropriate to enact changes in the taxation of oil and gas *now* because:

(a) Changes should be designed to meet our yet to be stated national petroleum objectives.

(b) There is as yet inadequate understanding of the consequences of change. Certain opinions and studies have been published (e.g., CONSAD Report) that come to erroneous conclusions because of invalid assumptions arising from this lack of understanding.

(c) In recent months there have been dozens of proposed changes that have been put forward as ways of achieving greater incentives at lower cost. To date these proposals when studied by the industry have not measured up to the stated expectations of the sponsors.

(d) The existing structure has evolved over forty years. It is not likely that an improved structure will be evolved without a careful objective study by both experienced operators and scholars. This kind of study has not yet taken place. It is most unlikely that changes motivated by political considerations will produce constructive changes in the national interest. We are confident that the industry would stand ready to participate in such a study as it is now contributing to the study of the imports question).

The deliberate approach being recommended need not take undue time. We believe it likely that a statement of national petroleum objectives will be forthcoming as a part of the President's decision on imports. An evaluation of our oil and gas taxation system could be prepared for consideration by the Congress promptly thereafter.

If the Congress feels constrained to act before the recommended studies have been completed, we respectfully submit that it should evaluate any changes in the light of the following: For reasons of:

(1) U.S. international freedom of action.

(2) Balance of Payments.

(3) The interests of our free world allies.

(4) Aid to developing nations.

We require—(in order of priority):

(1) A healthy domestic oil industry that can attract sufficient capital to find sufficient oil and gas in the U.S. to maintain appropriate reserve/production ratios. (Undue reliance on foreign oil should be avoided as long as possible.)

(2) A healthy U.S. participation in the Canadian oil and gas industry. (Canadian oil and gas should not be grouped with other foreign oil in light of geographic, economic, historical and political considerations.)

(3) Adequate and diverse sources of supply of foreign oil in the hands of U.S. companies.

Measured against these standards, we believe that on information now available it would clearly be a mistake to enact the anti-oil provisions discussed in II. above.

A. IV. EFFECTIVE DATES OF CHANGES SHOULD BE EQUITABLE AND GRADUAL

Effective dates of tax reform legislation should be set with two objectives in mind. They should not cause retroactive taxation and, where they will severely affect particular groups of taxpayers, they should be phased in gradually.

Incentive provisions that have been in existence for many years as a result of conscious Congressional policy decisions should in particular be protected from retroactive or abrupt elimination. These provisons have often been challenged in the past but they have to date always been reaffirmed. It would be unfair and inefficient to make changes with effective dates prior to the time the new provisions are signed into law. Earlier dates will catch many taxpayers in midstream and will impose burdens on transactions that never would have been undertaken had the new tax burdens been known in advance.

If changes are to be made in the tax structure applicable to oil and gas—a structure that has existed for forty years—the great number of people working and investing in the petroleum industry will need time to adjust to new tax levels if avoidable inequities and inefficiencies are not to be suffered. A gradual approach to tax increases proposed by H.R. 13270 is particularly appropriate with respect to the oil and gas industry because of the magnitude of the tax increases and the fact that they will fall in large part on income from investments made under present tax law. Thus, for example, if percentage depletion rates are to be reduced, they should, in no event, be reduced by more than one percentage point in any year. Should restrictions be placed on the extent to which foreign losses can be used as deductions, such restrictions should not be placed on losses arising from existing concessions. There should be at least a three-year grace period to minimize inequities relating to existing work commitments. We do not mean to suggest that a gradual elimination of these deductions would not produce undesirable effects. We do suggest, however, that a gradual change would produce fewer undesirable effects than an abrupt change.

There are examples of gradualism in H.R. 13270 and in the Treasury recommendations with respect to tax increases proposed for many groups of taxpayers. The concept is also made applicable with respect to rate reductions. A similar approach is called for to the extent that Congress decides that it should change the taxation of oil and gas at this time. Furthermore, if the investment tax credit is to be permanently eliminated from the Revenue Code, its repeal should be prospective and it should be phased out with a 1% reduction per annum rather than abruptly cancelled.

B. DISCUSSION OF SECTION 431 ("FOREIGN TAX CREDIT REDUCTION IN CASE OF FOREIGN LOSSES"), SECTION 432 ("SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO FOREIGN MINERAL INCOME"), AND SECTION 501 ("NATURAL RESOURCES")

The portions of the Tax Reform Act most adverse to U.S. oil corporations are Sections 431, 432 and 501. They are marred by the same flaws that are common to a large part of the Tax Reform Act: excessive and sometimes discriminatory new taxes imposed on a relatively small group of taxpayers; inattention to harmful long term consequences to the country; and statutory drafting that is often difficult to understand.

Section 431 ("Foreign tax credit reduction in case of foreign losses")

(*a*) *Summary*

Section 431 is applicable only to taxpayers doing business abroad and electing the per-country method of computing allowable foreign tax credits. It provides that if such a taxpayer sustains a loss in a foreign country, foreign tax credits attributable to profits subsequently earned there must be reduced under a highly complex formula. The purpose of the Section, according to the House Ways and Means Committee Report (page 117), is to permit the Treasury to recapture the U.S. tax benefits originally obtained by the taxpayer through the deduction of the loss.

(*b*) *Drafting flaws*

There are numerous drafting flaws in this Section. For example, it requires a disallowance of foreign tax credits even where the loss gave no U.S. tax benefit, it provides no time limit within which the recapture can occur, it contains no requirement that recapture can be applied only with respect to profits from the business operation that caused the loss, it can under rather ordinary circumstances cause a double recapture, it does not apply if an election to credit foreign taxes is not in effect in the loss year, and it can result in recapture upon the total abandonment of a loss project where nothing of value is salvaged.

(*c*) *Conceptual error*

More serious than the drafting errors is the misconception of the Ways and Means Committee (page 116 of the Report) that a U.S. taxpayer can now receive a double tax benefit by (i) deducting a foreign loss from domestic income in the year incurred and (ii) claiming a foreign tax credit against U.S. taxes otherwise payable on eventual income from that country. The implications are that the loss is deductible but the profit is non-taxable. The second implication is wrong. The taxpayer would have had no foreign tax credit to apply to the foreign profit if he had not first paid foreign tax on that income. The fact that the tax is paid to a foreign government is of no significance to the taxpayer. His tax burden in both the loss and profit years is exactly the same as if the losses and profits had been incurred in the U.S. (It may even be greater if foreign tax is imposed in excess of the U.S. rate.) This is precisely the result the foreign tax credit is designed to achieve.

(*d*) *Reasons for Rejection*

This Section, by prohibiting the crediting against U.S. taxes of certain foreign income taxes, deviates from the concept that foreign and U.S. income should be taxed in the aggregate at the same rates. This concept of tax neutrality is today firmly embedded in the Internal Revenue Code and in our international network of treaties prohibiting double taxation of the same income. The Section is particularly objectionable because it was included in the Act primarily as an indirect means of attacking international oil corporations' deductions for drilling expenses in foreign countries before profitable production is established. While not denying a deduction for these expenses, the recapture provision is designed to have substantially the same effect. This backdoor and extremely complex approach to the question should be rejected. If the deduction for foreign intangible drilling costs is to be restricted or denied, it should be done openly and only after a thorough survey of the economic and other consequences of such a change.

Section 432 ("Separate limitation on foreign tax credit with respect to foreign mineral income")

(*a*) *Summary*

Section 432 provides that a foreign tax imposed on foreign mineral income can only be used as a credit against U.S. income tax on mineral income from the same country, despite the fact that the taxpayer may have elected the overall limitation. It is designed to prevent heavy foreign income taxes imposed on mineral profits from being applied as credits against U.S. taxes on other more lightly taxed kinds of foreign income.

(*b*) *Justification*

The Committee Report (page 117) justifies this legislation on the basis of the alleged difficulty of determining whether a part of foreign income taxes paid on mineral production is really noncreditable royalty.

(*c*) *Reasons for Rejection*

High foreign taxes on oil production cannot be characterized as disguised royalties. Assistant Secretary of the Treasury Cohen in his statement on September 4, 1969 before the Senate Finance Committee noted that foreign countries often receive royalty payments greater than those paid in the U.S. He also noted that foreign countries frequently impose income tax on non-mineral income in excess of U.S. rates. Mobil Oil Corporation agrees with the Treasury's conclusion that Section 432 would work unfairly for mineral producing companies as compared with other U.S. taxpayers with foreign operations and that it should be deleted.

(*d*) *Treasury substitutes and reasons for rejection*

Mobil does not believe that the Treasury's substitute suggestions are well conceived. These involve a disallowance of excess foreign tax credits to the extent attributable either to percentage depletion or to foreign taxes on mineral income imposed at rates over 60%. Although the first suggestion is much preferable to the total disallowance of percentage depletion on foreign production proposed in Section 501 of the Act, it still would remove, unwisely in our opinion, a portion of the tax benefit stemming from the depletion allowance.

The concept of disallowing credits for foreign taxes in excess of 60% was reviewed by the Treasury before the Senate Finance Committee but was not recommended. In fact, the Treasury concluded that as a general matter, it is difficult to justify dealing more harshly with high foreign taxes on foreign mineral income than on other types of income. We agree that disallowance of foreign tax credits solely because they result from high foreign taxes on mineral income would be discriminatory and believe the idea should be abandoned.

Section 501 ("Natural resources")

Section 501 proposes two important tax changes affecting the oil industry.

Section 501(a) would change current percentage depletion rules and section 501(b) would convert certain mineral property interests into loan transactions.

(*a*) *Summary* (*Section 501*(*a*))

Section 501(a) would reduce percentage depletion rates on income from oil and gas wells from 27½% to 20% for domestic production and to zero for foreign production. Mobil Oil Corporation objects to these changes.

(*b*) *Justification*

Reduction in depletion rates is justified by the Ways and Means Committee (page 137 of the Report) on the grounds that the 27½% rate provides an unnecessary stimulant to drilling and that the revenue cost of depletion allowances and the resulting tax deductions to oil producers are too great.

(*c*) *Reasons for rejection* (*Section 501*(*a*))

The United States, through a multitude of U.S. enterprises, currently controls the ample, secure supply of reasonably priced oil and gas that is vital to the country's safety and well being. To tamper with this state of affairs by reducing or eliminating such a key incentive as percentage depletion without first making a careful forecast of its impact on exploration, production and prices would be a mistake. The only study of this question known to have been available to the House Ways and Means Committee as they considered Section 501(a) is a document entitled "The Economic Factors Affecting the Level of Domestic Petroleum Reserves" prepared for the Treasury Department during 1968 by the CONSAD Research Corporation and forwarded without comment by the Treasury to the Ways and Means Committee on March 11, 1969.

The CONSAD Report is filled with false assumptions, and is based on obsolete data. Perhaps its most significant error was the assumption that wells would continue to be drilled even where it was clear that their costs would not be recovered. The Report is not a proper basis on which to formulate legislative policy. It is submitted that, consistent with President Nixon's decision to retain the present oil import quota system until he has considered the report of the Cabinet Task Force on Oil Import Control, a decision on the merits of reducing domestic or foreign oil depletion rates should be postponed until a complete study, in which the oil industry is permitted to participate, is made of the effects of reduction.

(*d*) *Reasons for retaining foreign depletion* (*Section 501*(*a*))

Whatever decision is made as to the proper depletion rate for oil and gas wells, it should continue to be applicable to foreign as well as domestic production. There is no explanation in the Ways and Means Committee Report as to why the desirability of eliminating percentage depletion on foreign production outweighs its obvious disservice to the concept of tax neutrality except that at page 137 it is stated that foreign depletion "results in a large loss of revenue without commensurate advantages." In its analysis of the revenue effect of this elimination on page 138, however, the Committee Report predicts that all but approximately 10% of the $100 million gross tax revenue gain would, after 1970, be offset by unused foreign tax credits or eliminated by increased foreign taxes. Thus, it appears that the foreign depletion allowance has a net U.S. tax revenue cost of no more than $10 million per year, and that its elimination would soon result in foreign governments receiving $9 in extra tax revenue for $1 received by the U.S. Furthermore, there would be a predictable deterioration in our competitive posture as to new foreign exploration projects. The Treasury opposes the elimination of foreign percentage depletion. Mobil strongly supports the Treasury's position.

(*e*) *Summary* (*Section 501*(*b*))

Section 501(b) of the Act would add a new Section 636 to the Internal Revenue Code to provide that a mineral production payment, whether retained or carved out, would be treated as a loan to the owner of the underlying working interest rather than as a separate property interest held by the owner of the payment. The effect of this new rule would be to include the production payment in the income of the owner of the underlying working interest as the mineral is produced.

(*f*) *Reasons for rejection* (*Section 501*(*b*))

The propriety of treating any production payment as a loan is open to serious question, since in fact no loan exists and no party is obligated to make payments to another from his general funds. This is true whether or not an A-B-C transaction occurs and whether or not the payment is carved out or retained.

On a more practical level, retained payments are normally created when a mineral property is sold, and creating an artificial loan out of a retained payment would presumably reduce the purchase price of the property to reflect the tax that the purchaser would have to absorb on the income accruing to the production payment. The burden would then fall on the seller, typically an independent oil operator, and would strike another blow at the incentive to these persons to search for new oil and gas reserves. As is the case with the other portions of the Act directly affecting the petroleum industry, the effect of this removal of incentives can only be guessed, since no competent analysis has been made.

The proceeds of a carved out production payment are the economic equivalent of prepaid income received by any businessman for services or goods to be delivered in the future. At the insistence of the Internal Revenue Service, the courts have held for many years that prepaid income is taxable when received and not when the contract is completed by the seller. Section 501(b) proposed to reverse this rule for the mineral industry alone, so that the seller of a carved out production payment will not be considered, for tax purposes, to have received income until the actual production of the mineral has occurred. It is submitted that this is discriminatory legislation and should be eliminated.

STATEMENT BY JAYE F. DYER, EXECUTIVE VICE PRESIDENT, APACHE CORP.

UNIQUE FORMULA PROVIDES ECONOMIC THRUST

A unique tax formula has been at work in the United States over the past 35 to 40 years, giving powerful thrust to America's economic growth.

This formula embodies two key elements which, when applied together, have contributed significantly to the generation of the strongest, most dynamic economy in the history of mankind.

Those two elements are:

1. The progressive, confiscatory income tax
2. And, tax incentives

Taken alone, the high income tax rate stifles individual initiative and thereby becomes a deterrent rather than a thrust to economic growth.

But when combined, these two elements tend to encourage the flow of risk capital into the economy. Dollars taxed at lower rates would simply be paid in taxes. When subject to high confiscatory rates, these same dollars are attracted to investments which offer tax incentives.

Thrust has been given to the petroleum industry by this very combination of elements—the rapid increase in income tax rates in the early 1930s, following adoption of the depletion provisions, and then the vitally important provision for expensing intangible drilling costs.

During that 35–40 year period, our gross national product has catapulted from less than $60 billion to nearly $900 billion—testifying to the dynamics of the American economic formula.

To substantially alter either the income tax rates, or tax incentives applicable to the oil industry, would upset the fine balance and do immeasurable harm to not only the petroleum industry but our total economy as well.

INCENTIVES SHOULD BE BROADENED

Rather than reduce such incentives, they indeed should be broadened and put to work to meet other national needs, to solve social and economic problems just as they have helped create a strong and productive petroleum industry.

Similar incentives could attract risk capital into the solution of the shortage of low-income housing, the control of pollution, development of parks and recreational land, rural economic development.

American ingenuity, as demonstrated by your lunar landing, is capable of accomplishing virtually any objective it sets out to achieve. Given the economic incentive, the American investor will tackle any job deemed to be in the national interest. Americans want to invest . . . this is the basic cause of the American economic miracle.

APACHE CORPORATION IS A CASE IN POINT

My company, Apache Corporation, is a case in point. I can categorically state that we would not be in business today if it weren't for the dynamic combination of economic elements I have cited.

Application of that formula has made it possible, over the past 15 years, to build a $59 million corporation owned by 8,000 shareholders, employing more than 2,000 people in 11 states.

Apache's original business, and still our primary endeavor, is the operation of petroleum exploration and production programs for individual investors. Those investors are successful professional men and businessmen who are putting the product of their labors to work creatively. They are risking dollars in the highly speculative business of petroleum exploration in the hope of earning a return commensurate with that risk. Perhaps even more importantly, they are contributing to our National income by the discovery of new energy sources and the multiplier effect of their expenditure as it cycles through our economy.

Employing that private risk capital, Apache explores for and develops new oil and gas reserves throughout the United States and Canada.

For the sake of simplicity, I will deal in round numbers. Over the past 10 years, Apache has put some $100 million of normally taxable income to work in the search for and production of petroleum.

Of that $100 million, approximately $50 million would have been paid in federal income taxes had it not been invested in petroleum exploration and production. Thus, the high tax rates forced $50 million into the private sector of our economy, which was accompanied by another $50 million. It was attracted to the petroleum industry by the existing tax incentives.

Now let's take a look at the economic thrust those dollars generated:

1. The $100 million was paid principally as wages and salaries to employees of drilling contractors, petroleum service companies, and others supplying goods and services. It contributed to finding more than 300 million barrels of petroleum reserves.
2. $37 million have been returned to investors as their share of oil and gas sold thus far, with additional income to flow over a period of 20 or more years.
3. $9.5 million has been earned by the company and its shareholders for managing the drilling activity.
4. Three other company divisions have been spawned by the income and equity produced by oil. One operates public utility firms, another manufactures tools and equipment for industry and government, and the third develops and operates urban and suburban real estate.

The U.S. Treasury, too, has benefited directly from this economic thrust. As the attached chart (Chart I) shows, each dollar of tax incentive will generate $1.20 of taxes as it flows through our economy prior to reaching the Treasury.

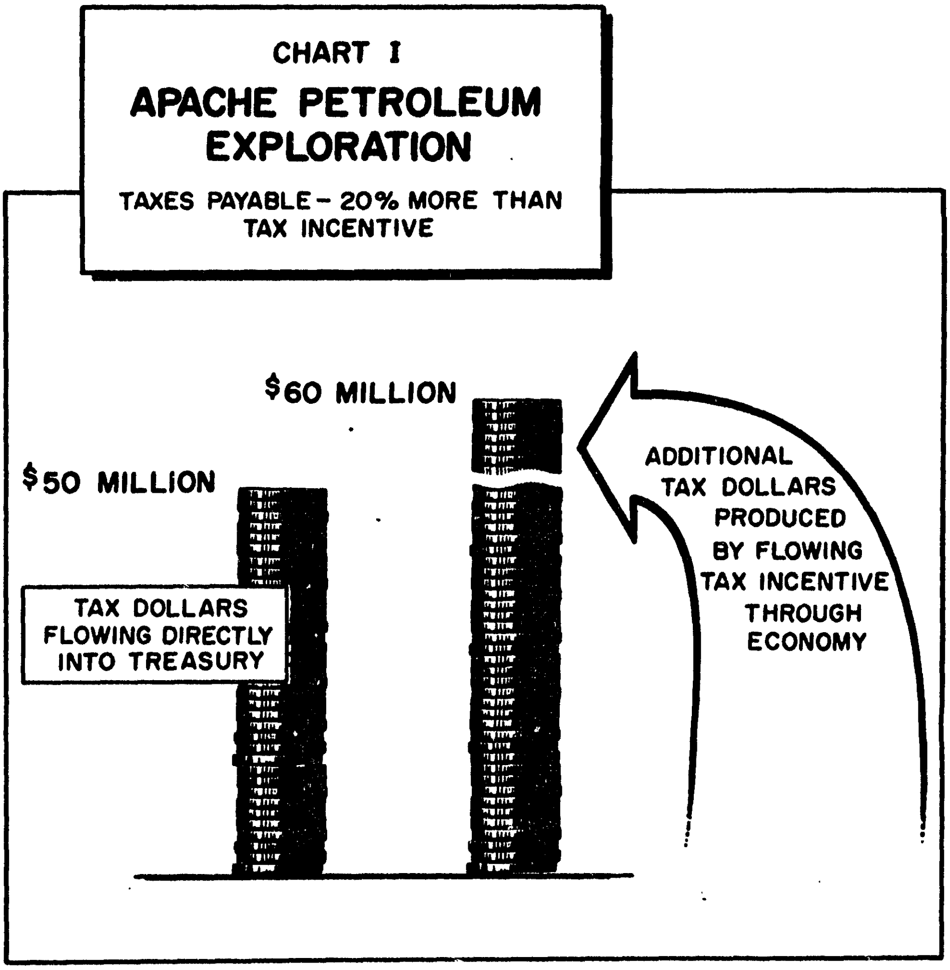


CHART I
APACHE PETROLEUM EXPLORATION
TAXES PAYABLE – 20% MORE THAN TAX INCENTIVE
$60 MILLION
$50 MILLION
TAX DOLLARS FLOWING DIRECTLY INTO TREASURY
ADDITIONAL TAX DOLLARS PRODUCED BY FLOWING TAX INCENTIVE THROUGH ECONOMY

1. Expenditures for services generates about $35 million of income taxes paid by wage earners.

2. Corporate suppliers will pay about $4.4 million in corporate income taxes.

3. Investors will pay about $21 million of income taxes on the production revenue derived from their share of the discovered petroleum reserve.

4. Therefore the $50 million tax incentive will provide about $60.4 million in taxes.

This represents only a portion of the multiplier effect caused by our confiscatory tax incentive system. Further, it is probable that none of the $100 million would be available if it were not for the incentives of the depletion provision and the deduction of intangible drilling expenses.

U.S. CAPITAL DEVELOPED CANADIAN INDUSTRY

Another case in point is the development of the petroleum industry in Western Canada. There is very little tax incentive for Canadian citizens to invest in petroleum exploration. But U.S. taxpayers derive the same benefit from an investment in that country as the United States. So, here again, the magnet of opportunity, supported by our dynamic tax formula, has attracted U.S. risk capital, totalling some $10 billion during the last 22 years, to the development of the vast Western Canada oil industry. By comparison, it is estimated that only $4 billion of Canadian capital has been invested there. Thus, major impetus to an important Canadian industry has been provided by U.S. dollars.

In passing, I would venture that the recent Alaskan oil discoveries, so important in our total domestic reserve picture, would not have been made were it not for the combination of tax elements cited here. Petroleum exploration of the North Slope began in about 1944 under the auspices of the federal government. Little economic value has been contributed to the nation by that activity. On the other hand, the petroleum industry, operating under the tax incentive system, began significant exploration in 1964, and this year—five years later—has increased the domestic reserve by at least 20% and has provided the State of Alaska with more than $1 billion and a continuing source of income for several decades.

WHY INCENTIVES ARE NEEDED

Critics of petroleum tax provisions are saying: "Why so much fuss about oil? The industry appears to be in robust health. World-wide supplies are almost limitless. A little belt-tightening in the interest of tax reform is a small price to pay."

These premises may all be true, considering the industry on a global basis.

But the very factors taken into account in initially establishing the tax structure for oil are even more salient today for the very survival of the domestic oil industry.

Other testimony, I am sure, has discussed these factors in detail, and I will not attempt to reiterate that evidence. Let me simply cite some of the key reasons why oil tax provisions should be preserved:

1. Our nation's defense and economic well-being require an adequate domestic source of oil.

2. A high risk factor works against the attraction of all but very speculative capital.

3. High costs have reduced the amount of drilling activity.

4. As a nation we are rapidly consuming known existing reserves, thus bringing about an impending shortage.

The threat of a petroleum shortage is not a theoretical one. It exists here and now and is most vividly seen in the diminishing availability of natural gas.

John G. Winger points out in the August 26, 1969 issue of "The Petroleum Situation" published by Chase Manhattan Bank, that conditions could rapidly reach a critical stage for the nation's natural gas industry and its customers.

As he indicates, gas is found incidental to the search for oil. And if the industry severely curtailed its hunt for oil in the United States, very little additional gas would be found, and although gas can be imported, the potential sources are limited and more costly.

On the basis of Chase Manhattan surveys, Mr. Winger has expressed the opinion to us that at least $3 billion *more per year* must be spent in the U.S. for oil exploration and development just to maintain our current level of self-sufficiency.

ECONOMIC PHILOSOPHY IN QUESTION

In reality, the point we face today in the discussion of so-called tax reform is a philosophical one: Who spends more productively, government or private enterprise?

The alternative to incentive is subsidy.

Speaking for but one small segment of a giant industry, I unhesitatingly go on record as being opposed to subsidy. Just as strongly do I urge the continuation of existing oil tax incentives:

1. The 27½% depletion allowance.
2. The deduction of intangible drilling expenses.

These are not "loopholes" in themselves. Their misuse is. And certainly I concur that the 155 millionaires who reportedly escape all taxes indeed are misusing these incentives.

Rather than diminish or curtail the incentives which, when harnessed to the progressive income tax system have given dynamic thrust to our total economy, let us expand those incentives and broaden them to other areas. In the hands of creative, motivated men they can produce solutions to our most crying national needs. And all America will benefit.

STATEMENT OF HENRY C. VAN RENSSELAER

Application of H.R. 13270 to Independent Canadian Oil and Gas Companies

My testimony is submitted as a United States citizen and as a Vice President and director of Bow Valley Industries, Ltd., an independent Canadian oil and gas company whose common shares are listed on the American Stock Exchange. I am deeply troubled over the effect of the provisions of H.R. 13270 relating to the elimination of foreign depletion and the provisions of that Bill and of the Administration's proposals relating to limitations on the use of deductions for intangible drilling expenses. I am concerned that enactment of any of these proposals will reduce the availability of Canadian oil and gas to the United States and will adversely affect the future of independent Canadian oil and gas companies. I am also concerned that enactment of any of these proposals will impede the economic growth of western Canada, and, concomitantly, reduce western Canadian purchasing power for United States products.

The interest of the United States in the continued development of Canadian oil reserves which are linked to the United States by pipeline and secure from the viewpoints of national defense and political stability is clear. It is even more clearly in the interest of the United States consumer that Canadian gas reserves, which now stand at 47.6 trillion cubic feet and are expected to eventually exceed 700 trillion cubic feet, be developed rapidly enough to prevent a major escalation in past prices in the United States, where domestic reserves are not at present considered adequate to accommodate the future market. In 1968, 47% of total Canadian gas sales of 1.29 trillion cubic feet went to the United States, the export percentage having risen from 14% since 1957.

Either the elimination of foreign depletion or the adoption of the restrictions placed on the use of deductions for intangible drilling expenses under the Allocation of Deductions provision of H.R. 13270 would have a substantial adverse effect on the future exploration for oil and gas in Canada. Enactment of the proposal of the Administration also to include intangible drilling expenses in the Limit on Tax Preferences unless at least 60% of the taxpayer's gross income is derived from the sale of oil and gas would be even more damaging.

Total oil and gas exploration expenditures in western Canada last year were just under $500,000,000, with independent companies drilling 59% of the exploratory wells. A survey conducted by the Independent Petroleum Association of Canada among the 125 companies comprising its membership reveals that in excess of $100,000,000 of the Canadian independents' annual exploration budget currently comes from United States individual and corporate participants with the greater part coming from individual spending. An example of the impact of the proposed legislation on this exploration is the case of our company, whose exploration program amounted to $4,004,128 in the fiscal year ended May 31, 1969. $3,307,084, or approximately 82.5%, was provided by a small group of United States individual investors who have notified us that they expect to terminate their activities with our company if Congress eliminates depletion on Canadian oil and gas production or restricts the use of deductions for intangible drilling expenses.

The elimination of foreign depletion would have a particularly serious effect on U.S. oil and gas investments in Canada due to a provision in Canadian tax law (to which the U.S. individual or corporate participant having operations in Canada is subject) classifying gains from sales of oil and gas property as ordinary income. This provision of Canadian tax law was enacted in 1962, at which time the Canadian law was also changed to permit certain purchasers of oil and gas properties to currently expense the cost of all land or production acquisitions. Under the combination of Canadian and United States tax laws to which a United States investor would be subject, in the absence of U.S. depletion there would be no way for such an investor to realize on his investment without paying either Canadian ordinary income rates with a top bracket of 80%, in the event of a sale, or United States ordinary income rates with a top bracket which is presently 77% (including the surcharge), in the event the property is held for income. Thus, if the U.S. depletion deduction were eliminated for Canadian oil and gas production, the U.S. investor would be taxed full ordinary income rates in Canada if he sold his interest and at full ordinary income rates in the United States if he operated it.

The proposal to restrict the full benefits of the deduction of intangible drilling expenses under the Allocation of Deductions provisions of H.R. 13270 is an additional factor making individual investors in Canadian oil and gas drilling ventures reluctant to make forward commitments at the present time; the threat of enactment of the Administration's proposal relating to including intangible drilling expenses in the Limit of Tax Preferences in the case of taxpayers deriving less than 60% of their gross income from oil and gas is even more serious. This is so because the exploration programs of a number of individual investors (who typically do not derive 60% of their gross income from oil and gas) have, to date, not been particularly profitable even under present tax laws. In the case of exploration programs managed by my company, investors over the last ten years have participated in 265 exploratory wells without experiencing a really significant discovery. While our exploration is primarily designed to find major reserves, and is, therefore, involved in a large percentage of high risk ventures, our results are closer to typical than the sensational discovery and "get-rich-quick" story which the public popularly identifies with the oil and gas independent.

The independents are the high-risk exploration arm of the Canadian oil and gas industry. Using their own cash flow and acting as managers for U.S. individual investors the independents habitually drill prospects which the major companies consider too risky to drill in their lower tax brackets. As a consequence, the independents drill many dry holes but they also make many of the major discoveries, indicating that exploration for oil and gas is a long way from being a precise science and that it still takes a lot of drilling and, at times, exploration concepts not necessarily developed by the major companies to find large reserves. In fact, the three most notable gas discoveries in western Canada during the past few years—Edson, Quirk Creek and Strachan-Ricinus—involving reserves expected to exceed 5 trillion cubic feet were all made by independents who use exploration funds provided by U.S. individual investors. During the same period the largest oil discovery in Canada was made by a small independent company in the Zama-Rainbow country in the northwestern part of Alberta. The company in question had experienced a decade of disappointing exploration results and investor discouragement. The discovery was made in an area written off by the major companies as gas-prone and opened up a trend which now has in excess of a billion barrels of proven oil reserves.

The exploration for oil and gas is a high risk business and cannot compete for capital with less risky investments unless the tax benefits are correspondingly high. Even under present tax laws the rate of return on invested capital for the oil industry is comparable to the rate of return of other less risky industries. Any cutback on the ability of taxpayers to deduct intangible drilling expenses or to secure depletion deductions on production will deal a severe blow to the independent segment of the oil and gas industry due to its reliance on exploration funds from individuals and corporations with non-oil and gas income. The result would be a further concentration of the industry in the hands of the larger companies and a lower level of exploration activity and eventual higher prices to the consumer.

Whatever the justifications may be for eliminating depletion on foreign oil and gas production, these arguments are not applicable to the Canadian situation. The discovery of additional Canadian oil and gas reserves is important to the United States for economic and defense conditions; recent discoveries on the North Slope of Alaska have served to confirm the potential of the Canadian Artic as a future major source of supply to North America. Accepting that fact, it is essential that a full tax deduction for drilling expenses be accorded to encourage investment in the type of expensive, high risk exploration ventures typical of northern development. The acknowledged argument in favor of domestic depletion—the stimulation of discovery and development of oil and gas deposits to make the United States self-sufficient and independent of questionable supplies of foreign oil and gas—has equal validity in support of depletion for Canadian oil and gas production.

In sum, I urge your committee to:

(1) retain the depletion allowance for oil and gas production in Canada; and

(2) retain the present unencumbered deduction for intangible drilling expenses.

There is, of course, well established precedent for shaping U.S. law and policy to take into account the special relationship between the U.S. and Canada, and especially their economic interdependence. Examples in point are the recent favorable treatment given Canada under the interest equalization tax and the Foreign Direct Investment Regulations. Furthermore, in view of the emerging unified Continental oil and gas policy, it would make no sense to discriminate against Canadian oil and gas exploration and production through U.S. tax legislation.

October 2, 1969.

APPENDIX E

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF NATURAL RESOURCES (OIL AND GAS)

Written testimony received by the committee expressing an interest in the subject of natural resources (oil and gas)

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., October 7, 1969.

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

DEAR SENATOR LONG: When Congress first instituted percentage depletion in 1926, it did so in reaffirmation of its belief expressed in the discovery depletion provisions of 1918, that an equitable system of taxing petroleum income was in the national interest. The Congress knew then that a society which was fast moving to higher levels of manufacturing and agricultural productivity would require plentiful supplies of economical and efficient fuel to energize its production machinery. It knew also that the high risks of exploring for oil and gas required fair incentives to attract investment of the capital needed to do the job.

This is why percentage depletion was enacted and this is why Congress has reaffirmed the provision after many, many examinations of the original provision.

How wise was the decision to provide incentives for capital investment is brought home to us in our daily lives through enjoyment of the highest standard of living in the world, a standard of living made possible in America by the effective and widespread use of petroleum which now provides 75% of the energy used by machines for producing goods; for generating power; for transportation; and for planting and harvesting our rich agricultural produce.

The United States now faces the greatest challenge in its history for finding oil and gas. In the next ten years, we need to find about 80 billion barrels of oil according to the Department of the Interior. We are advised that the capital requirements to explore for and to develop these new reserves are about double the average annual rate of investment for the last decade.

New capital certainly cannot be attracted and much of the presently employed capital cannot be expected to remain in this risky business if producers are burdened with the inequitable measures proposed in H.R. 13270. Exploration is vital to our national economy and to our national security. We must not in the future turn out to be a have-not nation dependent upon foreign powers for our energy supplies. Our national mineral resources policy should continue to encourage exploration and development of domestic petroleum reserves needed for the future. The policy has worked well in the past. It is required for the future.

I represent a District which has for many years been an important supplier of oil and gas to the people of the State of California. Thousands of people are employed in the petroleum industry of California, and California is the largest petroleum consumer in the nation. We need all the oil and gas we can produce in California and must also import supplies from other states. The future well being of the people of my District and of my State is heavily dependent upon adequate supplies of oil and gas.

Many of my constituents are small independent producers who would be especially hard hit by the provisions of H.R. 13270. Many of them would find their operations uneconomical if H.R. 13270 were enacted, and would find it necessary under the burdens of H.R. 13270 to shut down and abandon some of their present producing properties. This would be an irreparable loss to the people of California; would cause loss of employment; and would defeat the very purpose of the taxing statutes by drying up forever the sources of revenue which produce taxes. And I submit that what is a loss to the people of California is also a serious loss to the nation.

I have received letters from hundreds of people in my District protesting the anti-petroleum provisions of H.R. 13270. They object to any reduction in depletion. They also object to the other provisions of H.R. 13270, and to the related

33-865—69—pt. 5——73

proposals of the Treasury Department which are applicable to individuals in connection with including percentage depletion and intangible drilling costs in the computations under the Limited Tax Preference and allocation of Deductions provisions. They see these as little more than a thinly disguised and indirect attack on percentage depletion and intangible drilling costs. I concur in these views.

I most respectfully urge your opposition to all these unwise proposals which would undermine the incentives needed to help assure an adequate supply of domestic oil and gas for our economic well being and our national security.

Please make this letter a matter of record of the hearings presently being conducted by the Senate Finance Committee on tax revision.

Sincerely,

BOB MATHIAS,
U.S. Congressman.

STATEMENT SUBMITTED BY JOHN M. EVANS, DENVER, COLO.

Re proposed reduction of oil and gas depletion allowance.

GENTLEMEN: This statement is submitted on behalf of my wife and members of her family, several of whom own some mineral interests. The only income received from these interests is from leasing and, in a few instances, some oil and gas royalties.

The legislation now under consideration proposes to reduce the oil and gas depletion allowance from 27½ per cent to 20 per cent but it still allows a 50 per cent deduction on sale of long term capital assets.

One who owns minerals owns a capital asset. Oil or gas in place may be lost by migration but, of course, that is true of the surface of the land which may be lost by erosion or land slide, and land may be lost by the shifting of a stream which is a property boundary. Personal property which is a capital asset may be lost in many ways. Therefore, the migratory nature of oil and gas does not prevent its being a capital asset and it is so treated for most purposes in our Internal Revenue laws.

If the mineral owner's lessee achieves production of the oil or gas, the owner sells his share of the oil or gas (the royalty) just as the owner of any other capital asset sells his property and when the oil and gas deposit is depleted, the capital asset is gone for good.

We submit, therefore, that it is inequitable and discriminatory to allow the owner of a capital asset a 50 per cent deduction while allowing the mineral owner only 27½ per cent, using a cost base of zero on the oil and gas deposit, which is not usually the case. To reduce the depletion allowance from 27½ per cent down to 20 per cent would merely increase this discrimination.

An additional indirect effect of reducing the depletion allowance will undoubtedly be the reduction of the frequency of leasing, thus further reducing the income of the mineral owners.

Most of the arguments we have read in favor of reducing the depletion allowance, charging income tax "avoidance", seem to be directed toward the lessee-producers and statistics are generated to show how depletion and development costs as well as other deductions are pyramided to avoid paying what is argued to be a fair share of the over-all tax load. The statistics I have seen do not bear out the tax avoidance charges as a general proposition because I believe the figures show that oil companies have consistently paid a higher percentage of their gross receipts in income taxes than have manufacturing companies. However, if it is felt that the total deductions available to producers are too great the solution is not to reduce the depletion allowance but rather to place a lower over-all ceiling on the total deductions.

WASHINGTON, D.C., *September 29, 1969.*

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

DEAR SENATOR LONG: The tough limitations section of the House passed tax bill is a crippling blow to and could be a disaster to our nation's natural resources development. The tax provisions that have been the most effective part of the economic incentives for oil and gas are the very ones being diminished in H.R. 13270. Development of natural resources are a vital part of the national interest.

An analysis of the House passed tax reform bill clearly demonstrates that it would penalize a people and an industry at a time when capital expenditure requirements are at an all time high. Nearly one half of the capital requirement is obtained via this capital recovery tax method. In fact the capital requirements are now lagging for oil and gas. They should be nearly doubled each year for the next ten years in order to provide the general public the amounts of energy and fuels to meet their increasing needs. For the past two decades there has been a consistent relationship between the amount of capital invested in search of oil and gas and the proven reserves actually found. For the past nine years we have been falling behind; we are not finding as much oil and gas as we are consuming.

The House passed bill has had a chilling effect on the whole energy-fuels industry as well as all natural resources industries. It is restrictive and unacceptable, coming at a critical time when the national economic policy should be updated to implement and encourage innovation and new ideas in natural resources development giving opportunity to young men and women to develop them. The House Bill in its present form threatens to undermine the uniquely American energy-fuels system that is the one big part of modern technology whether in the home or on the highway, whether in the factory or on the farm, in peace or war, in the air or on the seas. The United States needs a growing, continuous and uninterrupted supply of domestic oil and gas. Without it, the United States of America would not be as we know it today or hope it will be in the future.

Sincerely,

ELMER L. HOEHN,
Former Administrator, Oil Import Administration.

POWDER RIVER OIL CO.,
Houston, Tex., September 5, 1969.

Hon. Senator MIKE MANSFIELD,
U.S. Senate,
Washington, D.C.

DEAR SENATOR MANSFIELD: We are an independent oil producer, with production in the state of Montana, as well as other states in that area. Amidst all the threats of legislation adverse to the oil industry, we want to point out a fact that possibly has escaped your attention, and that being the taxes we are presently paying to the state of Montana applicable to our interests there.

To refresh your memory, we are subject to five different types of taxes levied directly upon us: Crude Oil Production and License Tax Valorem Tax on personal property, Net Proceeds Tax and Individual Income tax. That is five not counting Unemployment Compensation Insurance, which is in reality a tax, and hidden taxes. In the year of 1968 we paid the State of Montana in excess of $82,000.00, and that was only the beginning. In 1969, the Montana Legislature enacted tax increases. In 1969, we expect to pay the State of Montana in excess of $101,000,000 in taxes, or a little over 8.6 % of our anticipated gross receipts from all sources in all the states where we operate. This figures to be in excess of 55% of our net income for Federal Income Tax purposes before deducting state taxes. Because we are a nonresident, our taxable income for Montana Income Tax can be greater than our overall taxable income for Federal Income Tax. Such was our situation for 1968, when our Montana Income Tax liability exceeded our Federal Income Tax liability.

We realize that all levels of government must have taxes, but there are so many of them that it is overpowering the source of the funds. There is the City, County, State and Federal, not to mention the School District, Road District, Water District and Hospital District, and all of them crying for more money. You may have heard, the legislature in our home state of Texas is at present in a second overtime period trying to write a tax bill to provide more revenue.

We don't oppose taxation. What we do oppose is this all our war on the petroleum industry. While all the others are enacting outright tax increases, the Nixon Administration is encouraging an attack on the other end by supporting a move to enact legislation that would cut the percentage depletion allowance and is rattling sabres at the intangible development charge-off. And, lest we forget, there is the Task Force on Oil Imports. The industry simply can't afford unrestricted oil imports that would ultimately result in decreasing our domestic reserves and create a dependence on foreign oil.

Senator Mansfield, we simply ask that while you are studying all of the proposals that will be presented to Congress relating to the petroleum industry, that you bear in mind the situation that exists in the states, particularly in Montana, and we think you will agree that the petroleum industry needs your help.

Very truly yours,

RICHARD C. MERCHANT, *Controller.*

TEXACO, INC.,
New York, N.Y., September 30, 1969.

COMMITTEE ON FINANCE,
U.S. Senate,
Washington, D.C.

GENTLEMEN: As Chairman and Chief Executive Officer of Texaco Inc., I feel it necessary to submit our views in opposition to the provisions of H.R. 13270, the Tax Reform Act of 1969, and to the proposals recommended to the Committee by the Treasury Department that would adversely affect the present income tax treatment of the oil and gas industry.

Based upon Treasury Department estimates, the so-called reform measures of the proposed Tax Reform Act would raise $1.6 billion of additional revenue in 1970, and of that amount over $500 million, or about one-third, would come from the petroleum industry. Furthermore, these figures do not take into account the additional tax burden that would be placed upon our industry by the concurrent legislative proposals to repeal the 7% investment tax credit and to impose a 10% income tax surcharge.

Most of the additional revenue that would be raised by provisions of the proposed Act that affect the oil and gas industry would result from reduction in the percentage depletion rate on oil and gas production from 27½ percent to 20 percent. Such a cutback in this long-standing incentive that has proven its value in generating and attracting the funds needed by the industry to explore for and develop new petroleum reserves would not be in the best interests of our nation and its citizens.

Our nation presently consumes almost 14 million barrels of petroleum products daily. This present demand is projected to expand to over 18.5 million barrels a day by 1980. To meet this demand and to maintain at least our present ratio of reserves to production, the industry must find some 70 billion barrels of new domestic reserves by 1980. To finance this search, the present $4.5 billion annual outlay for domestic exploration and development will have to be increased to over $7.5 billion. Continuation of the present tax incentives is essential if the industry is to generate and attract the funds needed for these outlays.

The present tax incentives are integrated into the economics of the oil and gas industry, and they should not be cut back. They have served the nation well, as is made clear by the industry's record of prices, profits, and taxes:

As to prices.—Prices of petroleum products have remained consistently low despite the inflation experienced in our economy. In terms of constant dollars, gasoline prices are lower now than in the 1920's even though there has been a tremendous increase in quality of the product.

As to profits.—The industry's tax incentives have not resulted in excessive profits. In fact in 1968 and over the last ten years the average rate of return on investment in the petroleum industry has been lower than the average for all manufacturing industries.

As to taxes.—The industry bears its full fair share of the nation's tax burden. Any valid comparison of tax burden must take into account all types of taxes paid. Total domestic taxes paid by the industry now amount to over $11 billion a year, comprising direct taxes of $2.5 billion and taxes on products of $8.5 billion. The direct domestic tax burden alone for the most recent year for which figures are available (1966) was 6.03¢ per dollar of revenue for the petroleum industry, as compared with 4.75¢ per dollar for industry in general.

Data compiled for the 21 largest United States oil companies show that their direct tax payments made to all jurisdictions in which they operate, both domestic and foreign, amouneted to more than 64% of their net income before such taxes for the year 1967. Texaco's tax payments were comparable, amounting to 60.3% for that year.

Our views on the necessity for continuing the present tax provisions relating to the oil and gas industry coincide fully with those summarized in the Department of the Interior's 1968 report, "United States Petroleum Through 1969," as follows:

"Both intangible expensing provisions and percentage depletion have been long-standing and durable features of the tax treatment of the petroleum industry, despite repeated efforts to change, reduce or eliminate them. They are an integral part of the petroleum industry's structure of income and expense, and the available evidence suggests that any substantial change in them would have a direct and significant effect upon the future availability and cost of oil and natural gas."

In addition to reducing the percentage depletion rate for domestic production, the proposals in H.R. 13270 would eliminate percentage depletion on foreign oil production. They would also restrict the effectiveness of existing treatment under which foreign income taxes are allowed as credits against United States taxes in order to minimize double taxation of foreign incomes.

These additional proposals would impair the ability of American oil companies to meet the severe competition of foreign controlled companies, which in many instances operate under an umbrella of subsidies granted by their home governments. If geographically dispersed petroleum reserves are to be developed by American rather than foreign owned companies, it is imperative that the United States companies remain competitive. If the United States were to impose discriminatory taxes or foreign tax credit restrictions to which foreign competitors are not subject, the result would be an eventual reduction in our foreign reserves to the detriment of our national security and our balance of payments. Furthermore, it has been recognized by Treasury officials of this and prior Administrations that the effect of repeal of percentage depletion on foreign production would be to penalize American companies, with no benefit to the United States Treasury; it would only result in foreign countries increasing their effective tax rates to "sponge-up" any additional tax revenue that otherwise would accrue to the United States. Hon. Edwin S. Cohen, Assistant Secretary of the Treasury, testified to this effect before the Committee on Finance on September 4, 1969.

Today unprecedented demands for revenue are being made to finance ever-growing government services. Along with these revenue demands, many proposals have been made in the name of tax reform. Where tax reform is necessary, it should be accomplished. And funds for legitimate governmental purposes should be raised. However, the increasing revenue demands and the proposals for tax reform must not be permitted to lead this nation into taxation policies which are unsound and which would be detrimental to national security and the overall best interests of our country.

Accordingly, and for the foregoing reasons which are elaborated upon in the attached statement, I respectfully urge that the Committee take no action that would reduce the long-standing and effective tax incentives applicable to the petroleum industry.

Very truly yours,

J. Howard Rambin, Jr.

Statement of Texaco, Inc., in Opposition to the Provisions of H.R. 13270 and to Treasury Proposals That Would Adversely Affect the U.S. Petroleum Industry

The provisions of H.R. 13270 and the Treasury Department proposals that would adversely affect the petroleum industry by impairing the value of existing tax incentives to search for and develop new petroleum reserves should be rejected. Also, the restrictions upon the foreign tax credit as proposed in H.R. 13270 and by the Treasury Department would reduce the effectiveness of the credit in minimizing double taxation of foreign income and should not be adopted.

A. THE PERCENTAGE DEPLETION RATE SHOULD NOT BE REDUCED

The proposal in H.R. 13270 to reduce the percentage depletion rate on domestic oil and gas production from 27½ percent to 20 percent is not in the best national interest, as can be demonstrated by a review of pertinent consideration.

1. The industry's record as to prices, profits, and taxes

The 27½% rate for percentage depletion has been part of the statutory pattern of taxation for more than 40 years, and is an integral part of the economics of the oil and gas industry. Any objective review of prices, profits, and taxes of the petroleum industry will demonstrate that the present percentage depletion rate has proven effective, and has not resulted in economic distortion that require correction.

a. *Prices.*—Percentage depletion has helped our industry set a record that is second to none. It has fostered exploration for and development of new reserves, thereby providing an increasing supply of petroleum at consistently low product prices.

At September 1, 1969 the average retail service station price of regular gasoline, exclusive of excise and motor fuel taxes, was 23.99¢ per gallon, as compared with the 1957–59 average of 21.59¢ an increase of 11.1%. This compares with an increase of 29% in the consumer price index during the same period. Since the 1957–59 period, total taxes on gasoline increased from an average of 9.02¢ per gallon to 11.11¢, an increase of 23%.

Further, in 1926, the year percentage depletion was adopted by Congress for petroleum production, the average domestic retail price of gasoline was 21¢ per gallon. In September 1969 the average retail price of a far better quality of gasoline was up only about 3¢ per gallon from 1926, or about 15%, while the consumer price index more than doubled.

Also, at September 1, 1969, the average domestic tankwagon price of regular gasoline to dealers, ex tax, was 17.20¢ per gallon, an increase of only 5.3% from the 1957–59 average price of 16.33¢. This compares with an increase of 13% in the general wholesale price index for the same period.

The average well-head price of domestic crude oil in August 1969 was $3.10 per barrel, compared with $3.00 during the period 1957–59. Therefore, crude oil prices increased only 10¢ per barrel, or 3%, over this ten-year period, as compared with the 13% increase in general wholesale prices.

b. *Profits.*—The oil and gas industry does not make excessive profits. The annual study of corporate profits by the First National City Bank of New York for the year 1968 showed that the rate of return on the net assets of the oil and gas industry for that year was 12.9%, compared with 13.1% for all manufacturing industries. During the period 1965 through 1967 this rate of return on net assets was 12.5% for the petroleum industry compared with 13.5% for all manufacturing industries. During the decade 1959–1968 the oil industry rate of return was 11.5% as compared with 12.1% for all manufacturing industry. In 1968, 19 of the 40 major manufacturing industries surveyed were more profitable than the oil and gas industry.

A May 1969 *Fortune* magazine survey of the 500 largest domestic industrial corporations showed seven oil companies numbered among the 25 companies having the highest volume of sales. However, only one of these seven companies that ranked in the top 25 on the basis of sales made the list of the top 100 companies having the highest ratios of net income to invested capital, and that company (Texaco) ranked only ninety-ninth.

c. *Taxes.*—A study published in July 1969, by Petroleum Industry Research Foundation, Inc., entitled "Economic and Social Implications of Removing the Percentage Depletion Provision", showed that the domestic tax burden of the industry, excluding motor fuel and excise taxes, was higher than that of all business corporations. The data are as follows (cents per dollar of gross revenue) ·

	All business corporations	Domestic oil and gas industry
1964	4.31	4.82
1965	4.62	5.43
1966	4.75	6.03
3-year average	4.56	5.43

In 1966 the petroleum industry's direct domestic tax payments amounted to $2.5 billion (exclusive of motor fuel and excise taxes), or 6.03¢ per dollar of gross domestic revenues, compared to 4.75¢ for all business corporations, as shown above. If motor fuel and excise taxes were included, the petroleum industry's domestic tax burden for 1966 would amount to 21.3% of gross domestic revenues. For 1965, if motor fuel and excise taxes were included, the ratio of the total domestic tax burden to gross domestic revenues would be 20.8% for petroleum and 6.6% for all business corporations.

The magnitude of the tax burden on the oil industry is further demonstrated in a study of 21 of the largest domestic petroleum companies compiled by Price Waterhouse & Co. at the request of the Mid-Continent Oil & Gas Association and submitted to the House Ways and Means Committee. This study showed that U.S. income taxes applicable to adjusted income (generally U.S. source income) of the 21 companies amounted to 19.1% for 1966 and 19.4% for 1967. The study also showed that total U.S. and foreign income taxes of the 21 companies amounted to 36.6% of net income before such taxes in 1966 and 37.1% in 1967. Finally, since it is neither fair nor accurate to evaluate the oil industry's tax burden solely in terms of income taxes, the study showed that the total direct taxes of all kinds of the 21 companies amounted to 64.3% of net income before such taxes for the year 1966 and 64.2% for 1967.

Texaco is one of the 21 companies for which the foregoing data were compiled. Its direct tax payments constitute one of its largest costs, amounting in the year 1968 to over $1.2 billion. That amount was more than total payments made to employes and more than three times dividend payments to stockholders. The direct tax payments of $1.2 billion were exclusive of $1.3 billion of motor fuel and other taxes collected from consumers and paid to governments. The nature and extent of Texaco's tax payments are discussed more fully in Exhibit "A", attached hereto.

2. Petroleum reserve requirements

The ratio of domestic reserves of crude oil and natural gas liquids to annual production was 10.3 to 1 in 1968. This ratio is down from 13.5 to 1 in 1958. Our industry will have to discover some 70 billion barrels of new reserves in the period 1969–80 to meet anticipated demand and to maintain the present ratio of 10.3 to 1. This amounts to about 70% more than the 41 billion barrels found in the period 1957–68.

The magnitude of the task of discovering 70 billion barrels is best seen when we estimate the amount of money that will be required to attain this goal. It is estimated that some $90 billion (or an average of $7.5 billion a year) will be needed to carry out this undertaking. This amount is two-thirds greater than the $4.5 billion a year that the industry is currently spending for this purpose. The tax burden of the oil industry should not be increased by changing the present tax treatment.

3. The risks inherent in exploration and development of oil and gas reserves

Congress in adopting the depletion provision gave recognition to the particular risks in the oil and gas business. The risks are no less today than they were years ago. Wells are being drilled deeper and in more inaccessible areas, fields being discovered are generally smaller and less profitable, costs are increasing, and despite improved technology the only way of proving an oil and gas reserve is by drilling.

Ample evidence of the degree of risk involved is the fact that in 1968 only 1.9% of new field wildcats found a significant quantity of oil compared with over 3% in the late 1940's.

4. The national security

The present tax treatment of the petroleum industry has been one of the most significant factors in enabling this country to develop and sustain the petroleum productive capacity and reserves that have been essential for national security. The importance of the petroleum tax incentives will become even greater in the future as the costs and risks increase in exploring for and developing the volume of reserves needed to satisfy steadily increasing demand for petroleum products.

It is not enough that the United States maintain oil reserves with producing capacity only adequate to meet our normal requirements. The Middle East crisis which started in mid-1967 dispels any such notion. At that time it became necessary virtually overnight for the industry to draw some 500,000 barrels a day of additional domestic reserves for emergency shipments to the United States East Coast, Canada, and our Western European allies to replace supplies normally received from the Middle East and North Africa. Any action now which would impair the present incentives to develop new reserves and productive capacity would be to gamble with national security.

Presently, the domestic percentage of Free World reserves is on the wane - down from 15% in 1959 to 12% in 1965 to about 10% at the present. We can ill afford any further decline. In fact, with increasing costs and risks, enhanced tax incentives would be warranted.

B. FOREIGN DEPLETION SHOULD BE RETAINED

The provision in H.R. 13270 to eliminate percentage depletion on foreign oil and gas production is contrary to the national interest.

The tax laws of twenty-four countries contain some type of percentage depletion provision. Many of the provisions are modeled after the U.S. law, and the reaction in these countries could be detrimental to U.S. taxpayers if our government were to eliminate percentage depletion on foreign production. In at least one country there is a provision for automatic nullification of the local percentage depletion provision in the event a foreign producer loses its right to percentage depletion in its home country.

Elimination of percentage depletion on foreign production would increase the tax burden of U.S. companies without increasing revenue of the U.S. government. This conclusion is supported by the testimony of Assistant Treasury Secretary Cohen before the Senate Finance Committee on September 4, 1969, as follows:

"Our analysis of this provision indicates, in the light of our foreign tax credit provisions, that after a brief period it will probably result in foreign countries increasing their effective tax rates on income from oil and gas production to 'sponge up' any additional tax revenue otherwise accruing to the United States. Thus the denial of foreign depletion will increase the effective U.S. rate of tax on such income, which tax the foreign governments will then offset by increasing their rates. The end result will be that the U.S. taxpayer will pay additional tax to those countries, but no additional tax to the United States.

"For these reasons, the elimination of percentage depletion on foreign deposits on oil and gas is unlikely to increase U.S. revenues significantly, and will merely increase the burden of foreign taxes on U.S. businesses."

Elimination of percentage depletion on foreign production also would damage U.S.-owned companies from a competitive standpoint. U.S. petroleum companies compete with foreign-owned companies for the opportunity to develop and operate foreign oil fields. Many of these foreign-owned companies are strong, aggressive companies owned or controlled by foreign governments or, if privately owned, enjoy special tax or financial benefits from their governments. The following are examples:

Soviet bloc governments engage directly in oil production and export about one million barrels of crude oil daily, thus adding to the competitive forces which U.S. companies must meet.

Germany has adopted a system of subsidized loans to German nationals engaged in foreign petroleum exploration and development; also, overseas losses from petroleum operations can be offset against income otherwise taxable in Germany.

The U.K. grants cash incentives for oil and gas exploration and development.

French companies are permitted to deduct overseas exploration expenses from income derived in France.

Japan, in addition to financial aid to Japanese companies exploring overseas, grants bonus exploration deductions and has committed itself to support exploration in Alaska, Southeast Asia, Africa and the Persian Gulf.

The Netherlands does not tax profits earned abroad, even when they are repatriated, as long as the profits are subjected to taxation in the foreign country.

Elimination of the tax benefit for depletion on foreign production would place U.S. petroleum companies at a competitive disadvantage at the very time when foreign competition in this field is most intense.

Since its inception in 1926, percentage depletion has been applicable to both domestic and foreign petroleum operations, recognizing the principle of taxing both domestic and foreign income alike. The availability of this tax incentive in the case of foreign production has helped produce results that are consistent with our foreign policy objectives, and has fostered the military security and economic strength of the United States. The elimination of foreign depletion would inhibit such a positive contribution to our nation's goals in the future.

We, therefore, urge the adoption of the Treasury Department's recommendations that percentage depletion on foreign oil and gas production be retained, and that the provision in the House Bill to eliminate foreign depletion be rejected.

C. FOREIGN TAX CREDIT PROVISIONS SHOULD NOT BE CHANGED

1. Section 431 of H.R. 13270

Under this provision, a taxpayer who elects the per country limitation and who reduces his U.S. tax on U.S. income by reason of a loss from operations in a foreign country would have to restore this tax benefit when income is later derived from that country. Recapture would also occur when the taxpayer disposes of property used in the business that generated the loss, whether through abandonment or otherwise.

Section 431, in contrast to existing law, would deny full credit for foreign income taxes actually paid in the case of taxpayers who have elected the per country limitation, and through its complex procedures could subject foreign source income to double taxation. The proposal, therefore, would restrict the effectiveness of the foreign tax credit, which is intended to eliminate double taxation, and would increase the tax burden on U.S. companies and make them less able to meet the competition from foreign-owned companies. Accordingly, and for all of the reasons cited in part "B", above, Section 431 should not be enacted.

2. Section 432 of H.R. 13270

This provision would provide a separate foreign tax credit limitation in the case of foreign mineral income so that excess foreign tax credit generated with respect to such income could not be used to reduce U.S. tax on other foreign income. This rule would apply where (1) the foreign country from which the mineral income is derived exacts a royalty from mineral income; (2) the foreign country has substantial mineral rights in the property; or (3) the foreign country imposes higher taxes on mineral income than on other income.

Section 432 is allegedly designed to deal with the problem of distinguishing foreign royalty payments (deductible or excludable items) from foreign tax payments (creditable items). A royalty is paid to a government in its position as an *owner* of property. A tax is paid to a government in its position as *sovereign*. The two items are clearly distinguishable, and there is no necessity for a provision such as proposed in Section 432.

Assistant Secretary Cohen, in testifying before your Committee, recognized the fallacy of Section 432 when he stated:

"On further examination of the tax and royalty structure applicable to the international minerals industry, we do not feel that it is proper to characterize all foreign taxes on mineral income in excess of U.S. taxes on such income as disguised royalties. . . ."

"If, then, this separate limitation in the bill regarding mineral income is not justified on the ground that any foreign tax in excess of the effective U.S. tax on mineral income is a royalty, it works unfairly for mineral companies as compared to all other U.S. taxpayers with foreign operations.

"It completely denies mineral companies the opportunity, available to other taxpayers, to average the excess of foreign tax over U.S. tax on mineral income against any excess of U.S. tax over foreign tax on their other foreign income. This result occurs even though the foreign tax on the mineral income is at a reasonable rate judged by world standards and even though such averaging is precisely the purpose of the over-all limitation."

We concur in the present Treasury position of urging the rejection of Section 432 as passed by the House.

We do, however, oppose the Treasury's alternative proposal to deny the use of excess foreign tax credits that are generated by reason of the allowance of a U.S. deduction for percentage depletion on foreign petroleum production as an offset against U.S. taxes on other foreign income. Aside from complexities involved, this is merely an attempt indirectly to limit application of the percentage depletion provisions. Also, the proposal would restrict intended benefits of the foreign tax credit and would make U.S. petroleum companies less able to compete with foreign companies for foreign oil reserves. The proposal, therefore, should not be enacted.

In summary, the nation's present tax incentives, in conjunction with its crude import policies and its conservation practices, have worked well to serve the interests of the national security and the needs of the American consumer in normal times and during emergencies. It would, in our judgment, be a serious mistake to make any change in the tax incentives that would impair their effectiveness.

EXHIBIT "A"

TEXACO INC. STATEMENT WITH RESPECT TO TAX PAYMENTS

Due to current interest regarding taxation of the United States oil industry, Texaco presents the following information regarding its tax payments.

Texaco Inc. and its subsidiaries and affiliates conduct operations in every state of the United States and in virtually every country in the free world. Its direct tax payments, including its equity portion of payments by subsidiaries and affiliates, constitute one of its largest costs, amounting in the year 1968 to over $1.2 billion. That amount was more than total payments made to employes and more than three times dividend payments to stockholders. The direct tax payments of $1.2 billion were exclusive of $1.3 billion of motor fuel and other taxes collected from consumers and paid to governments.

Texaco's direct tax payments include income taxes, oil and gas production taxes, property taxes, and in the more industrialized countries, particularly in Europe, import and border taxes, and turnover taxes. Regardless of type and the precise manner in which imposed, all of these direct taxes constitute a cost of doing business. They are all a direct charge against income from operations.

The income taxes included in Texaco's total direct taxes represent payments to Federal, state and local governments in the United States and also payments to governments outside the United States on income earned abroad. In accordance with long-established principles of taxation applicable to all U.S. taxpayers, income taxes imposed by governments outside the United States are allowed as credits against United States income taxes applicable to the same income. This treatment is necessary in order to prevent double taxation which would make it impossible for U.S. companies to compete abroad.

Texaco's tax payments for the past three years were as follows, in millions of dollars:

	1966	1967	1968
Direct taxes:			
Income taxes	$365	384	472
Production and property taxes	87	101	106
Import and related taxes	554	533	487
Other taxes on operations	127	138	182
Total direct taxes	1,133	1,156	1,247
Product taxes collected from consumers	794	1,092	1,334

The income tax payments of $472 million for 1968 were equivalent to 36% of Texaco's net income for that year before deducting such taxes. The corresponding ratio of income tax to net income before such tax was 33.5% for the year 1967 and 35.1% for 1966.

Total direct tax payments of $1,247 million for the year 1968 were equivalent to 59.8% of net income for that year before deducting such direct taxes. The corresponding ratio of total direct taxes to net income before such taxes was 60.3% for the year 1967 and 62.7% for 1966. These direct tax payments are exclusive of product taxes collected from consumers and paid to governments. They are also, of course, exclusive of taxes paid by Texaco's more than 200,000 stockholders on dividend payments of $1.1 billion in the last three years.

The foregoing tax amounts and income data are those of Texaco Inc. and consolidated subsidiaries plus Texaco's equity interest in non-consolidated affiliated companies.

Texaco as a leading world-wide producer, refiner, and marketer of petroleum and its products bears a heavy tax burden—with direct tax payments of approximately 60% of its net income before taxes. Texaco's tax payments contribute substantially to the public revenues of the United States and of all countries in which it operates.

MILLER & CHEVALIER,
Washington, D.C., September 26, 1969.

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

STATEMENT IN SUPPORT OF PROPOSAL TO RESTORE THE PERCENTAGE DEPLETION ALLOWANCE TO CANADIAN GAS PRODUCTION

DEAR MR. CHAIRMAN: The tax reform bill as passed by the House (H.R. 13270, § 501) provides that percentage depletion will not be allowed for foreign oil and gas wells and that for domestic oil and gas wells the present rate of 27½% is to be reduced to 20%. This statement does not deal with the question of the level of the depletion rate, but only with the question whether the same depletion benefits should be extended to gas wells in Canada as in the United States.

Except for an infant industry in liquified natural gas, the economies of which are not yet well established, gas consumers in the United States are dependent on supplies which can be delivered by pipeline. As a practical matter, therefore, deficits in meeting United States requirements for natural gas must be made up, and are now being made up, primarily from Canadian production. If the total of domestic (contiguous United States) and Canadian supplies are inadequate for the United States market, the result will be a shortage in meeting market requirements with serious impact on both price and availability of gas within the United States.

Large-scale imports of gas from Canada began more than a decade ago. They have grown from year to year as demand increased without comparable growth in the United States reserves. In 1967 imports of natural gas into the United States from Canada (513.3 billion cubic feet) increased 18.9% over the prior year and were 42.2% of Canada's net production. Imports from Canada amounted to 3.07% of total United States production as compared to .4% ten years earlier. An even greater acceleration in the growth of imports will be required in the future. In 1968 for the first time in the history of the natural gas industry, consumption of United States gas reserves was greater than newly-discovered reserves in the United States. The growth in demand, now at a rate in excess of 6% a year, will continue to mount with increases in population, industry and income. Irrespective of short-term changes in the ratio of reserves to requirements, over the long term the shortage in domestic production is bound to increase. It bears emphasis that gas is not a renewable resource and that each year a substantial part of finite reserves is withdrawn from natural storage for use within the United States. The long-range resource strategy therefore must be to encourage the greatest possible development of the large Canadian gas resources to serve the United States and Canadian markets, so that the United States may continue to benefit from Canadian supplies in excess of Canadian needs. A continental approach to natural gas resources is essential in the interest of the United States. This approach is also in the interests of the Canadians, whose resources are far greater than those of the United States in relation to population and demand.

The retention by the Congress of the percentage depletion allowance for domestic production, although at a reduced rate, can only signify Congressional recognition of the need for the depletion allowance as an incentive for exploration for new petroleum supplies. The explanation of the House Committee on Ways and Means, in recommending elimination of percentage depletion for foreign oil and gas wells was that its action would permit "percentage depletion for these items to be confined to areas where it will achieve its objective of stimulating exploration and discovery of domestic reserves" (Report of the Committee, p. 138). The Committee's reasoning—that percentage depletion would encourage exploration and discovery of new wells (Report, p. 137) — is entirely sound, but its finding that "the granting of percentage depletion to income from foreign deposits results in a large loss of revenue without commensurate advantages" (Report, p. 137) misses the mark with respect to Canadian gas. As United States gas markets grow, there is substantially the same advantage in the assurance of supplies from Canadian sources as from domestic sources. In effect, United States consumers are already drawing on a common pool to meet United States requirements. It would be little short of disaster to shrink the pool to the reserves within the boundaries of the 48 states. Yet such a result would be implicit in withdrawing the benefits of the depletion allowance for Canadian gas production.

The fact that the United States can rely on Canadian commitments almost to the same extent as for its domestic supplies in itself argues strongly in favor of extending equal encouragement to United States taxpayers producing gas in Canada by the allowance of percentage depletion on the Canadian production.

We note that Assistant Secretary Cohen, in his statement to your Committee on September 4, 1969, recommends the deletion of the provision in the House bill which would deny percentage depletion to United States taxpayers on for 'gn mineral production. We urge your Committee to accept this recommendation.

Respectfully,

MILLER & CHEVALIER.
By DAVID W. RICHMOND.

SOUTHERN NATURAL GAS CO.,
Birmingham, Ala., September 10, 1969.

Re Natural Resources—Percentage Depletion, Section 501—H.R. 13270.

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

DEAR SIR: Section 501 of H.R. 13270 would reduce the percentage depletion rate for gas and oil wells from 27½% to 20%. We are opposed to the enactment of Section 501 because it is a demonstrable fact that our country's gas and oil reserves are declining at a rapid rate and there is insufficient new exploration. If the percentage depletion rate is reduced, present shortages of gas and oil energy supplies will be compounded and our nation's security and standard of living will be seriously affected.

The Committee's Print (pp. 77–78) offers seven reasons against the passage of legislation which would tamper with existing depletion allowance rates. However, one stands out above all the rest:

"(6) Proved oil reserves today are declining at a rapid rate in this country, and there is insufficient new exploration. What the industry needs is more, not less, stimulation to seek new deposits."

If depletion-aided oil and gas production were in fact a get-rich-quick bonanza of tax-free funds, new capital and new businesses would flood the field and the search for oil and gas would be booming because businessmen and investors tend to go into enterprises that return high earnings. In fact and despite the growth in energy demand and the slump in available reserves, men and money have been going elsewhere to seek profits.

The record shows that in the past 10 years oil-well drilling has slumped by a third in the U.S.A. and about 50% of the nation's independent oil companies have abandoned the business. U.S. oil reserves amounted to 13.3 times annual production in 1959, and declined to 10.3 times annual production by 1968, whereas domestic demand increased 41% during the same period. Although these trends must be stopped and reversed, the proposed change will achieve just the opposite result.

An adequate supply of oil and gas is essential to national security. Petroleum provides the fuel for planes, ships and vehicles and the basic ingredient of conventional explosives. In addition, petroleum supplies are indispensable to our standard of living because America enjoys a "high-energy civilization."

An adequate supply of petroleum depends, however, on a fair rate of return to the petroleum industry, commensurate with the inherent and substantial risks involved. Nevertheless, the rate of return on net assets invested in the petroleum industry (11.5%) is comparable to that for manufacturing generally (12.1%—1959–1968). Thus, although the present percentage depletion provisions have encouraged the exploration for oil and gas, they certainly have not generated unduly large profits for the producers. Rather, the consumers and the nation generally have benefited through the availability of oil and gas in ample quantities and at reasonable prices.

Southern Natural is a publicly-held natural gas company engaged in the production and purchase of natural gas and in the operation of an interstate natural gas pipeline system throughout the Southeast. Domestic, commercial and industrial customers, as well as numerous municipal gas distribution systems and other interstate pipeline companies, depend upon us to maintain gas supply and transmisson facilities. Our operations affect individuals and companies in Texas, Louisiana, Mississippi, Alabama, Georgia, Tennessee, South Carolina and Florida. Our operations are dependent upon the availability of gas and the availability of gas is directly dependent upon the activities of those who search for it. Hence, our interest in it is basic both to us and the region which we serve. It also has enormous material consequences to our nation.

We are vitally concerned with the availability of gas supplies and the adequate deliverability of gas. The mounting evidence shows, with disturbing clarity, that our nation's gas reserves are in serious jeopardy and that the ratio between gas reserves and gas consumed is decreasing. For example, recent pronouncements of the Federal Power Commission, the Bureau of Mines and industrial leaders authoritatively demonstrate these alarming facts. Of particular significance is the fact that during this session of Congress four members of the Federal Power Commission officially advised Representative Boggs of the House Committee on Ways and Means that a reduction in present tax allowances is "likely to result in applications to increase the Commission's area rates for natural gas sold in producing areas, and that such changes in the tax law, unless offset by rate increases or other relief, would also tend to reduce the level of exploration effort upon which new supplies of natural gas depend, at a time when the adequacy of gas supplies has been called into question." Even in dissent, the Chairman noted that the elimination or reduction of the statutory depletion allowance would tend to increase the cost of gas. We urge you, therefore, to take the common-sense, practical approach and permit the allowance to remain as it is.

Although your Committee Print (p. 77) lists four arguments for adoption of the changes in the depletion allowance, we submit that there is only one real reason why changes are being suggested at this time. This argument—or "reason" is:

"(2) Percentage depletion is symbolic of a preference-prone tax structure that discriminates against persons whose incomes are wholly or principally from fully taxable wages and salaries. To leave it unchanged would invite the breakdown of our voluntary, self-assessment system of taxation."

As we have already shown, the practical effect of the percentage depletion provisions in our tax laws has been to make available more oil and gas and at lower prices than would otherwise prevail. To suggest, therefore, that the economic welfare of the petroleum industry be sacrificed as a "symbol" of a preference-prone tax structure is to make a mockery of the tremendous efforts of that industry in that past and to scorn its endeavors for a better present and a progressive future.

We are convinced that the petroleum industry is being offered as a scapegoat in 1969, at a time when the problems of 1979 and 1989 and 1999 should have the foremost place in your minds. Our customers need gas now and will need more of it then. We must satisfy their needs to survive and they need us to survive. Above all, the entire nation needs gas, as an energy, if its security and standard of living are also to survive. Shortsighted symbolic sacrifice, if inflicted, will be disastrous to all of us and to our country.

Respectfully submitted.

PETER G. SMITH,
Vice President, General Counsel and Secretary.

STATEMENT ON BEHALF OF GEOTHERMAL RESOURCES INTERNATIONAL, INC.

INTRODUCTION

This statement is submitted on behalf of Geothermal Resources International, Inc. (hereinafter "GRI") to request the Senate Finance Committee to clarify existing law with respect to the definition of "gas" as that term is used in the Internal Revenue Code of 1954. The Tax Court of the United States has recently held in *Arthur E. Reich, et al., v. Commissioner* (52 TC No. 74, July 31, 1969) that geothermal steam is a gas. Accordingly, the Court held that participants in successful steam drilling ventures are entitled to deduct percentage depletion. Moreover, that the petitioners were entitled to elect to expense the intangible costs of drilling and developing geothermal steam wells. It is our understanding that the Internal Revenue Service, undaunted by this setback, intends to continue to disallow both depletion and intangibles for all taxpayers engaged in this industry and to force such taxpayers to litigate these issues. To obviate this wasteful expenditure of both time and money, we respectfully request your Committee to direct in the legislative history of H.R. 13270 that the term "gas" as used in the Internal Revenue Code includes geothermal steam. A summary of the reasons for this action is set out below.

BRIEF HISTORY OF GRI

A brief discussion of GRI's activities is included in this statement since we believe GRI is typical of the small young company which is pioneering the use of geothermal steam as a source of electrical energy in the United States. GRI is the survivor of a 1965 merger involving four small corporations, each of which had prior to the merger either been engaged in the drilling for geothermal steam or owned interests in land believed potentially capable of producing geothermal steam. GRI is presently engaged primarily in the business of drilling for and producing geothermal steam for sale as a source of energy for generating electric power to be used by industry as well as other consumers of electric power.

Since 1966, GRI has restricted its drilling efforts to areas in Sonoma and Modoc Counties, California, but, with advances in technology and the availability of land for additional drilling, GRI hopes to expand these operations. In the summer of 1967, GRI drilled the GRI-Rorabaugh #1 steam well as a discovery well in an area now designated by the company as the Rowan Steam Field in the Geysers area of Sonoma County, California. The well was completed at a depth of 6,676 feet after encountering the tope of the productive interval at a depth of 6,400 feet. The company subsequently drilled six additional wells, designated GRI-Rorabaugh #2-7 (all located in close proximity to the well #1), two of which are presently capable of producing geothermal steam, and four of which may well produce steam upon the completion of remedial drilling. GRI has financed the drilling of these wells in part through private equity offerings under permits issued by the California Commissioner of Corporations. Without the availability of the right to expense intangible costs of drilling and developing geothermal steam wells and the right to deduct percentage depletion on income received from successful wells, GRI will be unable to secure the additional capital needed for further exploration.

DISCOVERY OF GEOTHERMAL STEAM

Actually, in a few foreign lands, geothermal steam is old hat. For example, Icelanders use natural steam to heat their homes, and Italians built the first power station using natural steam at Larderello in 1904. The Italian field now boasts a 400,000 kilowatt rating which is nearly matched by similar fields in New Zealand. Most of this activity occurred many years ago but recently in other foreign countries, there has been a surge of interest in the geothermal process. Countries now exploring and developing geothermal steam include Mexico, Japan, Russia, Nicaragua, El Salvador and Guatemala. Research on the subject is being sponsored in some less developed countries by the United Nations.

In the United States geothermal steam has, until recently, been considered uneconomic. However, with technological improvement and more complete geological surveys, the use of geothermal steam to generate electric power holds great potential. Recently, Union Oil Company of California, Magma Power Company and Thermal Power Company formed a joint venture to drill for and sell geothermal steam from Northern California wells to Pacific Gas & Electric Company. Although no one knows the ultimate potential of geothermal steam, some forecasters give it only a small percentage of the market—perhaps 2 or 3 per cent, but in such a huge market even 2 or 3 per cent is a tremendous amount of electric energy. It is estimated by Dr. James McNitt, formerly a geologist for the California Division of Mines and Geology and now a geologist for the United Nations, that there are more than 1,000 known geothermal regions in Western United States. Of these, he says, only 11 have been drilled extensively enough to assess their potential.

Drilling and geological evaluation indicates that the techniques used to locate oil and natural gas are applicable in the search for natural steam. The entry of prominent oil companies into the natural steam industry has resulted in an accelerated application of petroleum exploration methods. In addition to field mapping, such procedures as sub-surface studies through electric log correlation, gravity surveys, magnetometer surveys and heat sensing surveys are now commonly employed in the quest for steam accumulations. Steam wells, like oil wells, may be drilled with rotary or cable tool drilling equipment, and although the drilling technique is quite similar to that used in oil, the blow-out preventive equipment on steam wells must handle much higher temperatures than comparable equipment on oil wells.

The first step in drilling a steam well is to select the well site and stake the point where a drill will pierce the surface. The site is graded and leveled to accommodate the drilling rig as well as the other equipment necessary for operation. The well site includes mud sump or pit varying in size in relation to the depth the well will be drilled and a well cellar to accommodate the blow-out prevention equipment. The equipment used in the actual drilling of the well includes the mast or derrick, pipe rack and 40-foot lengths of pipe, drill collars and bits, mud tank for drilling fluid, diesel engines to power the mudpump, portable generators and floodlight equipment, christmas tree or well head equipment to contain high pressures and the various hand tools and rig safety devices used in any drilling operation.

The derrick is rigged up over the drillpoint and drilling commences to a shallow depth, whereupon surface or guide casing is cemented into place. Drilling is then continued through water-bearing horizons, perhaps, to a depth of 2,000 feet, whereupon a second string of casings, known as the water string, is run to depth and cemented into place to prevent contamination by surface waters. Drilling continues to the projected depth usually between six and nine thousand feet. GRI's wells have depths ranging from 6,500 feet to 7,280 feet with the total footage drilled to date approximately 50,920 feet, including five redrills. A reservoir of steam was encountered in the GRI-Rorabaugh #1 well at about 6,400 feet below the surface of the ground, and the cost of this discovery well was approximately $250,000. The cost of the second well was nearly $750,000 while the remaining wells have been drilled at an average cost of approximately $475,000. The high cost to drill the second well was due to mechanical and other difficulties encountered during drilling and should not be considered as truly representative of the cost to drill an ordinary steam well. Although a supply of steam has been discovered at relatively shallow depths at a cost of $50,000 to $75,000, in GRI's experience such finds represent rare exceptions rather than the rule.

Once a well is determined to be capable of producing steam, both in quantity and pressure sufficient to warrant the expense of completion, a pipeline gathering system, consisting of large diameter fully insulated pipe is attached to the wellhead. This system runs to a point where pressure regulating equipment necessary to control the steam pressure and/or volume is located. The pressure regulating equipment is connected to a steam turbine by expansion joints and pipelines. The controlled steam pressures and/or volume is used to turn the turbine which, when directly connected to a generator, produces electricity. At the point where the steam has spun the turbine, its energy is, for all practical purposes, dissipated. It is uneconomic to transmit steam for long distances, and accordingly, electric power plants which use geothermal steam as a power source, must be located at, or very near, the steam wells. Transmission lines from these power plants are then connected to the grid system.

Recently, GRI retained International Engineering Company, Inc. to prepare an analysis of the cost to construct a 300 megawatt plant, exclusive of transmission, interconnections and switching costs. This analysis presupposed the construction of two 50 megawatt and two 100 megawatt plants, and the total estimated cost was $32,000,000. Although the tremendous costs connected with the development of geothermal steam as a power source for the production of electric energy exceed similar costs for oil and natural gas, the benefits to be derived from the use of geothermal steam are well worth the expense.

BENEFITS OF GEOTHERMAL STEAM

The use of geothermal steam as a power source for electric energy has several significant advantages, not only to the consumer, but to the general public. Based on our experience (and the experience of the Union Oil—Magma—Thermal group), we project that geothermal steam, when produced in adequate volume, will compete very favorably with other sources of electric power. Indeed, once the generating plants are constructed, we project that electric energy produced from geothermal steam can be sold at from 25 to 40 percent less than the current cost of producing such energy under conventional methods per kilowatt hour. These figures are real—not mere projections. For example, the Union Oil—Magma—Thermal joint venture is selling steam to Pacific Gas & Electric Company at a profit and Pacific Gas & Electric, through its well-site turbines, generates electric power at a cost 20 percent below that for conventional fuels.* Presently, Pacific Gas & Electric has a total rated capacity in its geothermal power system at the Union Oil—Magma—Thermal wells of 82,000 kilowatts, and Pacific Gas & Electric has recently announced two additional units to be completed in 1971 and 1972, raising its capacity to 192,000 kilowatts.

In addition to lower prices, geothermal steam has two other significant benefits—the complete lack of air and water (thermal) pollution. Nuclear power, viewed by many as the key to generating electricity in the future, has one serious drawback—it contributes substantially to thermal pollution. As this Committee is well aware, air and water pollution are high on the list of the serious problems facing this nation. The production of electric energy from geothermal steam not only is free from air pollution but also creates no water pollution which would endanger fish or other aquatic life. Moreover, no demand is made on existing water supplies.

The availability of a low cost power source of electric energy which is completely free from air and water pollution can not be overlooked. Initially, the beneficiary of such power will be California, the state with perhaps the best known smog problem. Various sources estimate that the power demands in California will double in the next seven years and will continue to double every ten years thereafter. It would, however, be clear error to suggest that only California will benefit from geothermal steam as a power source. Some estimate that geothermal steam could be used on a nationwide basis. We are unable to confirm or deny such estimates, but we are convinced that it can be of significant benefit to all Western and Southwestern states within a relatively short period of time.

CONGRESSIONAL ACTION IS NECESSARY

As noted above, the Tax Court of the United States held in *Arthur E. Reich et al.*, v. *Commissioner* (52 TC No. 74) that geothermal steam was a gas as that term is used in the Internal Revenue Code of 1954. Nevertheless, the Internal Revenue Service intends to continue to litigate this issue forcing taxpayers to expend both time and money in defense of court-approved deductions. Further, and perhaps of even greater significance, taxpayers in the geothermal steam industry will be unable to raise additional capital to finance new exploration and development of steam wells so long as IRS continues its present policy. In an effort to change that policy, we request this Committee to clarify the legislative history of the term "gas" by stating in its Committee report on H.R. 13270 that the term gas includes geothermal steam for all relevant provisions of the Code.

There should be little doubt that geothermal steam is a natural resource which should be developed as a polutant-free source of electric energy. The discovery of, and drilling for, geothermal steam utilizes the techniques of the petroleum and natural gas industries. The entry of prominent oil companies into the natural steam industry has resulted in an accelerated application of these exploration methods. The expert testimony presented in the *Reich* case *supra* establishes that geothermal steam is contained in a closed reservoir, in a finite amount, with no significant liquid influx. The only recourse we have to stop further IRS attach is for this committee to direct in a legislative history of H.R. 13270 that geothermal steam is a gas for all relevant provisions of the Internal Revenue Code.

Geothermal Resources International, Inc., stands ready and willing to supply any additional information which the Committee might desire and to assist the Committee or its staff in any way.

Thank you for the opportunity of presenting our views.

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*This cost figure was contained in a Wall Street Journal article dated June 10, 1968.

CONSAD RESEARCH CORP.
Pittsburgh, Pa., October 9, 1969.

Senator ALBERT GORE,
U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR SENATOR GORE: Please find enclosed, *per* your request. CONSAD Research Corporation's comments on Mid-Continent's Oil and Gas Association Critique of CONSAD's report, prepared for the U.S. Treasury Department, entitled "The Economic Factors Affecting the Level of Domestic Petroleum Reserves." I hope you find these comments useful: essentially, as our comments indicate, we believe Mid-Continent's Critique to be so replete with inconsistencies and out of context references that it appears to be an outright attempt to obfuscate, confuse, and mislead.

Thank you for your interest in this matter.

Sincerely,

WILBUR A. STEGER.

Enclosure.

COMMENTS ON MID-CONTINENT (MC) OIL AND GAS ASSOCIATION CRITIQUE

I. INTRODUCTION

The critique and evaluation of the CONSAD report entitled, "The Economic Factors Affecting the Level of Domestic Petroleum Reserves," by the Mid-Continent Oil and Gas Association is so replete with inconsistencies and out-of-context references that it appears to be an outright attempt to obfuscate, confuse, and mislead.

The MC report is notably lacking in *constructive* criticism. At no point does the report indicate how the CONSAD model might be improved, how the data might be improved, or what alternative methods and models might be used for analysis to develop more accurate estimates of the effects of the special tax provisions. This suggests that perhaps the authors prefer to have no analysis made.

The inability of the MC report to find any serious fault with the CONSAD report conclusions after apparently concerted study only serves to increase the credibility of these conclusions.

The covering letter contains a glaring inconsistency, which is repeated in the body of the report. In paragraph three, the MC cover letter implies that the CONSAD model is erroneous because when extrapolated to below-cost prices it indicates that firms would continue to find and develop reserves. In paragraph five, the CONSAD report is deprecated for extrapolating a considerably smaller amount. Thus, the MC report indicates that extrapolation beyond the range of the data is justification for placing no credence on the results, then proceeds to extrapolate even further to illustrate the "inappropriateness" of the CONSAD model. The MC report also seriously overstates the amount of CONSAD's extrapolation. The price change equivalent to the elimination of percentage depletion is about 35 cents (not 75 *cents* as stated in the MC report) which is a comparatively small extrapolation—the largest year-to-year price change in the data was 30 cents.

II. OBJECTIVES OF CONSAD STUDY

The CONSAD study was designed to evaluate the efficiency of the special tax provisions in encouraging petroleum producers to maintain reserves *above* those necessary to support current production. The primary justification voiced in recent years in defense of the special tax provisions regarding the petroleum industry was the necessity of encouraging a large reserve level to insure adequate supplies of oil in time of a sudden increase in demand due to a national emergency.

Although the MC statement of a fixed technology relationship between reserves and production is not supported by available data, the existence of such a relationship would not prevent producers from maintaining excess reserve stocks if economic incentives were offered to encourage this. The CONSAD study was aimed at determining the effectiveness of the special tax provisions in increasing oil reserves *above* those levels needed solely to support production.

The conclusions of the study that the special tax provisions were inefficient means for achieving such an objective remains a valid conclusion. Throughout the study, CONSAD took pains to *inflate* the effectiveness of the special tax provisions as an incentive for holding reserves. Consequently, if better data became available, its analysis would probably show that these tax provisions were even less efficient than is concluded by the CONSAD report.

If the intent of the special tax provisions is to encourage consumption of petroleum products by keeping prices below their free market levels, the CONSAD study offers no evidence as to the effectiveness of the tax provisions.

It is very possible that petroleum production will decrease if the special tax benefits are reduced or eliminated. Such a decrease would take place if the producers passed the added tax burden on to consumers and consumers then reduced their consumption. A decrease might also occur if producers were currently producing at the limit of available capacity, since the tax increase would make marginal wells unprofitable to operate. Such a producer-initiated decrease might not occur if production restrictions, such as allowable production days, were relaxed, allowing more efficient production from existing wells.

III. SPECIFIC COMMENTS ON THE MC REPORT

Examination of many of the allegations made in the MC report leads only to the conclusion that the authors of this report either (a) did not read the report, (b) did not understand the report or the economic theory on which it is based, or (c) both. The concluding statement in the summary says that "The model used is especially subject to criticism because it is based on the improper assumption that industry exploration and development expenditures are not dependent on an adequate rate of return." No such assumption is either explicit or implicit in the CONSAD models, and such a statement implies a rather extreme lack of knowledge of the contents of the CONSAD report.

The technique of quote-out-of-context is used on page two of the MC report to attempt to invalidate the supportive evidence of CONSAD's third model. What the CONSAD report actually stated was that the quantitative estimates obtained from the model of the individual firm could not be used as estimates of industry reaction, since all the various types of firms in the industry were not represented in the model.

The CONSAD report stated that the third model would substantiate the first model if the indicated reserve changes were of the same order of magnitude, and were changes in the same direction. The results obtained from the third model *did* substantiate the results of the first (or neoclassical) model.

Surprisingly enough, after indicating that only the first CONSAD model was worthy of comment, much of the MC report is devoted to specific criticisms of minor points concerning the other models discussed in the CONSAD report.

On the question of uncertainty, the MC report is somewhat erroneous in stating that the CONSAD report assumes perfect knowledge. The report does not assume this, nor is such an assumption implicit in the methodology.

Another out-of-context quote is provided on page 15, where Eisner's objections to Jorgensen's model are noted. The remainder of Eisner's article goes on to propose modifications in Jorgensen's model similar to those used by CONSAD (the CONSAD model is credited to the Eisner article quoted in the MC report).

The MC report appears completely confused on page 21, where the CONSAD report is taken to task for using a 12:1 reserve ratio figure is not, of course, used anywhere in the model. It is mentioned as historical background, but the data used in the model were actual reported reserves and production.

The MC report seems confused again on page 31 when it indicates that "This approach leads CONSAD to compare the price of a *full* barrel of reserves with the cost of only a *fraction* of a barrel." This is not true, but as the MC report offers no explanation of its statement, no comment can be made.

There are two important points to be made concerning the "apparently incorrect information," cited in the MC report (Section IV). The first of these is that careful reading of the report would make it quite clear that all of the items cited were presented as background information in the study and do not form the basis for any results derived therein. The second of these is that, with one exception, the statements in the CONSAD report were true when the data was being collected and the report was being written. The use of 1968 data, which were obviously not available when the report was written, (the study involved over a year of continuous effort) to illustrate the "incorrectness" of statements in the CONSAD report cannot be interpreted in any other way than as an obvious attempt to discredit the CONSAD report, since anyone with any knowledge of the petroleum industry would be aware of the basic sources of the CONSAD statements.

Most of the discussions in Section V, *Doubtful Petroleum Economics*, is replete with the same sort of out-of-context quoting of the rest of the MC report. The only relevant information presented here is that in reference to Professor McDonald's work on the non-neutrality of a flat-rate corporate income tax. It is interesting to note the omission from the MC report of Professor McDonald's conclusion that a percentage depletion rate of 14% would provide the desired neutrality.

Professor McDonald's work, however, does not examine the *efficiency* of percentage depletion as a method for compensating the non-neutrality of the flat-rate corporate income tax. It is certainly possible, and a subject worthy of further study, that some more direct method of compensating investors for the risk elements in petroleum investments would provide the desired neutrality at a much lower cost to the economy.

IV. CONCLUSION

CONSAD would welcome some meaningful critiques of its work, with the ultimate objective of imposing the reliability of the conclusions. Unfortunately, the Mid-Continent report is totally useless for this purpose.