91st Congress } 1st Session COMMITTEE PRINT

S2114

TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED MONDAY, SEPTEMBER 29, 1969

PART B—ADDITIONAL STATEMENTS

(Topics: Public Utilities Depreciation—Earnings and Profits, Etc.: General: Interest Deductions: Conglomerates—Installment Method: Tax-Exempt Organizations—Advertising Income: Multiple Surtax Exemptions)

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

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
33-758 O WASHINGTON : 1969

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SUMMARY OF MOSS TAX STATEMENT:

Congress must pass genuine tax reform which plugs up the major tax loopholes; Congress must use this extra revenue for tax relief for the middle and lower income taxpayers; and Congress must to this now, this session.

Major tax loopholes include:

1) The untaxed appreciation of assets transferred by non-charitable gift or death;

2) the tax exempt status of municipal bonds;

3) hobby farming;

4) accelerated depreciation of real estate;

5) the 25 % maximum and six month holding period for capital gains;

6) the oil depletion allowance, and

7) the unlimited charitable deduction.

Closing these loopholes should bring in at least an extra $8 billion which should be passed on to middle and lower income taxpayers.

The House bill is a good beginning but does not deal adequately with hobby farming, tax-free bonds, and appreciation of assets transferred at death or by non-charitable gifts.

The Nixon Administration recommendations are also indefensible, since they cut $1.7 billion from the average taxpayer's relief and turn it over to corporations in the form of a 2% reduction in the corporate tax rates, and since they back away from having a tough minimum income tax provision.

STATEMENT OF SENATOR FRANK E. MOSS (D-UTAH)
SENATE FINANCE COMMITTEE
SEPTEMBER 29, 1969

SUBJECT: Tax Reform Amendments of 1969

Mt. Chairman, I appreciate this opportunity of appearing before you and our other distinguished colleagues on this committee. You have a formidable job ahead of you, and I will not take 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 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 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 non-charitable gift or at death, 2) the tax-exempt status of municipal bonds, 3) hobby farming, 4) accelerated depreciation of real estate, 5) the 25% maximum and the six-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 would also seek a better solution to the tax-free 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.

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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% reduction in the corporate tax rates.

After ramming through a 10% 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 relief 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 meagre 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.

Let us seise this opportunity now.

STATEMENT OF JOHN B. CONNALLY
HOUSTON, TEXAS

ON BEHALF OF THE

LIVESTOCK PRODUCERS COMMITTEE

WITH RESPECT TO H. R. 13270

I. Introduction

My name is John B. Connally of Houston, Texas, where I practice law. I am appearing here on behalf of the Livestock Producers Committee, a group of approximately 50 farmers and ranchers in the Southwestern United States. I should add, however, that since I was raised on a farm and have owned farms and ranches in Southwest Texas since 1951, I am also appearing on my own behalf.

II. Current Economic Situation in Farming and Ranching

Many of you are familiar with the deplorable economic situation of the farmer and rancher in the United States. Nevertheless that economic situation should be outlined and illustrated as a backdrop to an examination here of some of the provisions of "The Tax Reform Act of 1969" with respect to agriculture.

One of the witnesses before the Ways and Means Committee in the hearings on this bill referred to the "tragic

cost-price squeeze" on those engaged in American agriculture. I could not agree more; we have a crisis arising from the costs of the farmer-rancher rising faster than the proceeds from his production. For all of this century those in the agricultural business have bought in a seller's market and sold in a buyer's market.

This "squeeze" is illustrated graphically by Chart 1. You will note that since 1950, the earliest year shown, the major costs of producing livestock have risen steadily but the retail price of livestock, particularly beef, has risen only slightly. Now only 16% of the consumer's disposable income, the lowest percent in modern history, is spent on food, which is the greatest bargain in the American marketplace.

A rancher has been able to absorb these spiraling production costs without comparable meat price increases only by cutting his profit margin to the vanishing point. For example, to obtain an economic profit of $3,100 in the cattle business today, a recent Texas A&M University study concluded that an investment of $112,000 was needed,

a return of less than 3%. Even that return is inflated because <u>it does not include anything for the rancher's labor or overhead</u>. 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.

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 non-fertility, disease problems, and wrong types of animals often requires heavy culling during the first few years of a breeding herd development. Revenues during this period are extremely low and the results frequently lead to unprofitable operations for several years.

In a recent publication from Purdue University the author made the following statements regarding capital availability:[2]

> Financing and capital avilability has played an important part in the development of the beef industry. The quantity and availability of capital has influenced the development and production of feeder cattle, cattle feeding, processing, and the distribution of beef to varying degrees almost since the establishment of the industry.
>
> This willingness and ability of outside financing to invest in the various aspects of producing cattle and feeding

them had undoubtedly been a factor contributing to the continued expansion of the industry during recent years. . . .

Cattle feeding certainly could not have progressed to the point it has in terms of size and scale of operation without the availability of large amounts of capital. . . . Investments totaling several millions of dollars in both fixed and operating capital are not uncommon for these operations.

Outside capital flowing into agriculture has resulted in improved land, developed new breeding stock, refined technological developments, and has paid for public and private agricultural research.

Beyond this, as General Rudder will discuss more fully, it has also been responsible for thousands of demonstration farms at the local county level. The entire concept of demonstrations, which are usually handled by the local county agricultural agents, depend upon the ability of the agricultural producer to withstand the additional costs involved in adjusting his production, maintaining additional records, and encompassing additional cost expenditures, to

demonstrate a new technological development or new technique to his neighbors.

It must be recognized that much of the land clearing, brush removal, stock pond building and improved pasture development which has occurred in the United States in the livestock production areas has, in fact, been accomplished by the larger producer. The real issue at stake is whether or not this individual will continue to improve the agricultural productivity of the Nation's farmlands, if he is discouraged by the Federal tax laws.

The battle against brush is a continuing one, and it is one in which, even for all the monies which have been expended, we seem to be losing. Massive water development plans for the Southwestern part of the United States can, in fact, transform these arrid regions into virtual productive gardens. In the meantime, however, such areas of the country must depend upon the private and personal sector of the economy to provide stock ponds for livestock and privately financed irrigation projects in order to maintain the

productivity of the area. All this can be placed in jeopardy and good sound range management conservation measures abandoned if the present tax laws are changed (except for the provisions suggested herein).

The tremendous investment involved in land improvements is emphasized in the Journal of Farm Economics by Philip M. Raup.[3]

> In accounting for recent land-value increases it is also appropriate to examine recent investments made in land and consequent improvements in the quality of the land input. One of the most prominent investments in quality improvements has been soil conservation, including structures, land-protective measures, and tillage practices. Another prominent investment in land has resulted from rural electrification, improved water supply, and water distribution and storage systems.
>
> Between 1932 and 1959 a total of 7 billion dollars was spent for conservation purposes in the U. S. Some part of this, and perhaps the major part, has had long-run effects on the quality of the land factor, and should be reflected in higher values.

Frequently, it is these farmers and ranchers with substantial outside capital who have been the major supporters of agricultural research at the Experiment Station in land grant universities through private

research fund donations. A study performed in California and reported in the Journal of Farm Economics indicates that not only has the financial support of such groups and individuals been quite substantial but that the time lag between the initial project instigation and the actual accomplishment of the technological advancement has been shortened considerably through the use of these additional funds.

Probably no one statement has best expressed the real needs for increased capital in agriculture than that made by Mr. Gene L. Swackhamer with the Federal Reserve Bank of Kansas City.[4]

> The change in agriculture that we now perceive is not a sudden development--only our attention has made it seem so. Small-unit agriculture was the dominant feature of our agrarian past. The family farm was cherished and protected because it represented the very best that our democratic society could offer to man. The farmer was laborer, manager, and, generally, land-and-capital owner all in one. At his best, he was an entrepreneur in the truest sense.
>
> . . . Yet, almost from the day the first fence went up in the prairie, agriculture was undergoing change.
>
> . . . Land, labor, and capital are still agriculture's principal resources, and

the farmer is still the entrepreneur masterminding their productive combination. Yet, the mix of resources is ever changing and the entrepreneural role of the farmer is much changed from the nearly self-sufficient status of pioneer farmers.

. . . In addition to changes in farm size, the land tenure pattern of farming has moved toward part ownership. As reported by M. L. Upchurch, Administrator of the USDA's Economic Research Service, only 7 per cent of full owners had farms with sales of $20,000 or more in 1964, compared with 24 per cent of the part owners and 16 per cent of tenants.[5]

. . . Capital has become agriculture's fastest growing productive resource. This, too, can be seen in Chart 1. The use of purchases nonfarm resources such as machinery, equipment and production items has increased the need for agricultural credit. The use of credit in agriculture has been expanded rapidly since 1950, while the total farm economy has been growing at a more modest rate. Cash receipts from farm marketings have increased at a 2.5 per cent average annual rate, compared with nonreal-estate farm debt which has increased at an average annual rate of 8.6 per cent. The average annual increase in realized net farm income since 1950, however, has been only about .8 per cent--reflecting increasing input prices relative to product prices, and the use of a higher proportion of purchased inputs. Clearly, accumulating sufficient capital for efficient farming

is a problem--implying that the need for farm credit will continue to be extensive.

Another aspect increasing the capital requirements for maintaining a large beef breeding herd is the growing size of the market. Today the United States has become a major exporter of beef breeding cattle. During the year 1968, exports of beef breeding cattle reached an all time high of slightly over 20,000 head. This represented an increase of 17% over the 1967 level. Most of this increase was due to increased exports to Chile and Canada, although Mexico continues to be the leading export outlet for U. S. beef breeding stock. Venezuela ranks as the second most important market with Canada third, and Chile fourth.

Other countries which purchase substantial numbers of U. S. beef breeding cattle are Guatemala, Costa Rica, Ecuador, Brazil, Panama, Republic of South Africa and the Phillipine Islands.

The Hereford breed led all others numerically in 1968, but the Brahman breed ranked second in importance. It is interesting to note that high on the list of breeds of cows exported are the American developed breeds of

Santa Gertrudis, Beefmaster, Brangus, Charbray and Braeford as well as various other cross-breds that were not identifiable as to breed.

The exportations of beef breeding cattle requires tremendous capital. This capital is utilized in advertising, contracting, litigation, foreign trips and numerous merchandising techniques required to conclude such sales. Such foreign sales cannot be undertaken by individuals with limited capital. The beef breeder who desires to enter this foreign market must have the financial resources to withstand all the normal market development costs involved.

The leading State in the United States for the exportation of beef breeding cattle is Texas. Not only does Texas account for well over one-third of all the beef breeding cattle exported from the United States but it, together with Florida, accounts for almost 60% of the total of such exports. Two-thirds of all the exports of beef breeding cattle in the United States are from the States of Texas, Florida, Arizona, New Mexico and California.

The Ports of Houston and Galveston are the major points of debarkation for the United States exportation for beef breeding cattle, particularly those destined for Latin American countries.

The exportation of beef breeding cattle represents a rare event to the agricultural field; it is one of the few livestock commodities that is exported from the United States, and one of the even more rare commodities that is exported for cash, and not under a government subsidized program. Such exportations, therefore, accomplish numerous goals: (1) they gain foreign exchange for the United States; (2) they provide higher quality animals to foreign countries which, in turn, can be utilized to upgrade their own domestic herds, and (3) they offer the seed of a new commodity - beef - which can be used to raise the standard of living in these underdeveloped countries.

The magnitude of agriculture's economic impact upon the supplying industries is tremendous, and can be best illustrated by the following passage which is

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taken from the introduction in the Yearbook of Agriculture, 1968:[6]

> In the mid-1960's, farmers were spending annually about 3.4 billion dollars for new farm tractors and other motor vehicles, machinery, and equipment - providing jobs for 120,000 employees.
>
> They annually purchased products containing about 5 million tons of steel and 320 million pounds of rubber - enough to put tires on nearly 6 million automobiles.
>
> They use more petroleum than any other single industry - and more electricity than all the people in industries in Chicago, Detroit, Boston, Baltimore, Houston, and Washington, D.C. combined.

It has been noted by the U.S.D.A. that the innovators of the agricultural community are also the principal purchasers of farm real estate. So too are these larger more progressive producers, the big users of the latest technology, the newest equipment, the larger quantities of fertilizer, and also the experimenters of new breeds, techniques and production methodology.

As the price of labor increases because of higher wage rates, agricultural producers are moving toward

more labor-saving devices. The result is an increased reliance upon more capital expenditures for such equipment. This concept of increasing capital requirements as labor requirements decrease on the farm is examined by an agricultural economist in the Journal of Farm Economics.[7]

> Is it possible that withdrawal of labor has forced the producer's attention to labor-saving techniques and to equipment that can be used effectively only with relatively large acreages? As labor becomes scarce and increases in value, operators shift to capital substitutes that can enjoy economies of scale over lower ranges of input. The tractor, for example, permits substantial economies of scale up to a given leval of rate of use per year. To put it to work requires more land. Greater efficiency can be achieved by adding more acres, and part of this economic advantage can be bid into the price of land needed to bring unit cost down. This can lead to an active demand for land, associated with withdrawal of labor. It is possible to conclude that a withdrawal of labor contributes to an increase in the price of land or creates offsetting forces that keep the value of land from falling relative to labor.

A great man once wrote:

> No man is an island, entire of itself;
> every man is a piece of the continent,
> a part of the main; . . . .[8]

I most respectfully say to you that agriculture is not an "island" unto itself that can or should be blocked off from the infusions of capital so necessary to it; it is a "part of the main" stream of progressive America.

Let us be honest with ourselves. A small ranch can no longer support a family. No return of less than 3% or a loss is going to attract new capital so desperately needed. The farmers and ranchers need a continuation of most of the present provisions of the Internal Revenue Code in the manner I shall indicate.

III. The Farm Loss Problem

I do not say that the provisions of the Internal Revenue Code with respect to farming and ranching should be left as they are. As is so often the case, over the years practices develop that are in essence abuses of the spirit of the Internal Revenue Code and the regulations thereunder. This is true in every area of tax law.

Now in the last few years it has become apparent that some people have gone into the livestock industry solely, or primarily, for the tax advantage. Neither the Livestock Producers Committee, nor any other person that knows the agricultural industry defends these "abuses." So far as I can tell there is no person appearing before this Committee that defends that taxpayer who has been called "a Wall Street cowboy."

Today I speak only for the farmers and ranchers who are engaged in the agricultural business for an economic profit. Naturally there is a problem in distinguishing the legitimate farmer-rancher from those who seek only a "tax profit." As indicated above with respect to capital needs, the fact of non-farm work or income is not an appropriate test. Leaving aside capital requirements, practicality requires a recognition of the fact that, according to the latest census figures, 46% of all farmers and ranchers in the United States reported some days of work off their farms and 32% reported such work amounted to 100 days or more. The importance of non-farm work can be judged from the fact that last year it provided well over half of the

total income of those farmers with less than $10,000 in farm sales. Even the farmer whose farm sales exceeded $40,000 derived 17% of his income as the result of non-farm work.

These figures demonstrate that whether you are large or small the rancher or farmer has "outside" income in an increasing amount.

In addition, legitimate farmers and ranchers cannot be separated from the "tax profit" investor by the amount of non-farm income test as proposed in essence in H.R. 13270 or by other bills before this Committee. In justification of such test the Ways and Means Committee Report stated that as a taxpayer's adjusted gross income increased, the average size of his loss also increased. This is only to be expected in a normal business operation. All other things being equal, if there is to be a loss, a large business probably in a risk operation will lose more actual dollars than its smaller counterpart.

Yet it is important to note that the same statistics show that the losses represented a smaller percentage of adjusted gross income as the size of the enterprise increased. I have here a chart which illustrates this

(Chart No. 2). For example, farmers and ranchers with adjusted gross incomes of less than $15 thousand had an average net farm loss of over 22% of their adjusted gross incomes. Farmers and ranchers whose adjusted gross incomes were in excess of $100 thousand had net farm losses amounting to about 6% of their adjusted gross incomes.

IV. Statutory Changes Congress Should Adopt

There are certain concrete steps that can be taken by Congress to prevent the "tax profit investor" from utilizing the present law (or at least one interpretation thereof). The Livestock Producers Committee urges your approval of four provisions of H.R. 13270. These are:

1. Extension of the recapture of depreciation provisions to breeding animals.

2. An increase in the holding period for which breeding animals must be held in order to obtain capital gains treatment on their sale.

3. Clarification of the non-applicability of the tax-free exchange provisions of the Internal Revenue Code to exchanges of male and female calves.

4. Recapture on disposition of land improvement costs, which were deducted currently, in the same manner that depreciation is recaptured on depreciable realty.

In my judgment these changes will put a reasonable stop to schemes which derive their profit from offsetting ordinary income deductions with capital gains in those cases where there is no real objective of an economic profit. In other words these steps will eleminate the "tax profit investor."

V. The "Overkill" Provisions

Nevertheless, the Treasury and the Ways and Means Committee have not stopped with these changes, but have gone on to far more radical provisions that will substantially destroy the essential qualities of American agriculture that I outlined above.

Pesticides, for example, although once hailed as the salvation of agricultural industry, are now being severely restricted for possibly causing detrimental affects on human beings through the animals and foods we consume. In our quest to eliminate certain harmful insects, we have gone too far and the benefits previously

praised have now boomeranged and bombarded us with disaster.

So too will be the effect of provisions designed to make farming and ranching undesirable to the so-called "tax farmer" but also unattractive to those who have capital from non-farm sources that could be placed into agricultural enterprises. Care must be taken, not only to protect the small farm and ranch operations, but also the larger ventures that have provided an abundance of food and fiber for the American citizen. We cannot afford to jeopardize the American consumer by artifically and suddenly revolutionizing the economic base of the agricultural industry. As any economist would admit, the institutional influences upon the agricultural economy of the United States are profound. Any drastic changes, therefore, in the institutional perimeters must be carefully analyzed so that their economic impacts are thoroughly understood and that they would be in the long-run beneficial to the general welfare.

H.R. 13270 imposes unique restrictions on the agricultural industry. The House Bill: (1) creates

The Excess Deductions Account concept, (2) singles out farm losses for treatment as a tax preference item under both the Limitation on Tax Preferences and the Allocation of Deductions, and (3) creates a presumption that a ranch is a hobby if its losses exceed $25,000 in any 3 out of 5 years.

Aside from the disastrous rejection of needed capital by these provisions of the Bill, these extremely complex concepts have a further basic difficulty. (The provisions also contain a number of apparent technical deficiencies which are discussed in Exhibit "A" hereto.)

VI. <u>The Obvious Difficulties of the Accounting Problem.</u>

A fundamental difficulty of the "overkill" provisions arises from the use of what the Treasury described as "deviations from good accounting practices." As an example, the Treasury stated that normally in businesses where the production or sale of merchandise is a significant factor, income can be properly reflected only if the costs of the merchandise are deducted in the accounting period in which the income from the sale of that merchandise is realized, i.e., the accrual method of accounting. As a policy of long standing, farmers and ranchers have been permitted

to use the cash accounting method in which such expenses are deducted in full when incurred. The Treasury added that these agricultural provisions "were permitted for farm operations in order to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting." Apparently the Treasury would argue that those farmers and ranchers who have outside income of any substance should be restricted in the use of the cash accounting rules because some of that non-farm income might be offset by the farm losses.

This kind of reasoning will not stand examination. Congress' past approval of the rancher's use of the cash method of accounting does not stem solely from a desire to spare him accounting problems. The most important reason for using the cash method is that under the peculiar nature of the agricultural business, the accrual method of accounting does not yield more accurate results. The typical rancher raises livestock both for sale and for adding to his breeding herd. If it

were possible to always know which animals were destined for which purpose, then it might be possible to make allocations of ranching expenses between animals held for sale and breeding stock so that the accrual method of accounting would give a more accurate picture of income. Unfortunately, the rancher does not know this until many months after the animal is born.

Moreover, many agricultural operators engage in both farming and ranching operations. The difficulty in accurately allocating expenses in such situations has been succinctly summarized by the Attorney General of the United States in a brief recently presented to the United States Supreme Court:

> [T]he nature of farming and ranching operations makes an effective accrual method of accounting difficult to operate. Each employee almost invariably worked on numerous phases of the farm's profit-making endeavors, such as planting and harvesting crops, raising livestock, repairing fences and barns, etc. Thus, it was exceedingly difficult to allocate salaries and the other expenditures among those farming operations.[9]

Frequently there is no way in surveying a farm loss that a farmer or rancher can tell how or in what percentage his loss arose. Yet the penalty provisions

provisions apply. For example, suppose the loss can be allocated to a maize operation; the farmer-rancher loses his capital gain in culling his breeding herd in an equal amount. It is difficult to see any logic whatsoever in such result.

In summary, the provisions of H. R. 13270 require that every substantial farmer or rancher keep his books of account on the strict accrual basis or face the possibilities that a part of his usual deductions will be disallowed and that part of any capital gains he might have in future profitable years will be converted into ordinary income. Yet even if the expert accounting help is available to the farmer or rancher, the Attorney General of the United States has admitted before the U. S. Supreme Court that an "effective accrual method of accounting" is exceedingly difficult "to operate."

VII. Rise in Land Prices

A major complaint raised before the Ways and Means Committee, as to this Bill, as well as by other bills pending before this Committee, is related to higher land prices for the small farmer.

This complaint can be considered only if answers are provided for the three basic questions:

1. Are "tax-profit" farmers really pushing up the price of land?
2. Do high land prices work for or against the bona fide farmer?
3. Do higher farmland values benefit the general public?

If we examine these questions separately and in detail, the results will demonstrate that the complaint is not only, in fact, unfounded, but may be premised on the opposite of the actual situation.

Are "Tax-Profit" Farmers Really Pushing Up the Price of Land?

An analysis completed in 1967 at Texas A & M University dealt with the Texas farm and ranch land market. The authors in their publications state:

"Factors considered relevant to a general analysis of Texas land market activity are per acre price, volume of land sales, size, mineral activity, availability of credit, interest rates, veterans land board activity and land use." 10

Although the research study devotes considerable time and detail to each of these various influences upon land prices and statistically quantify some of their magnitudes, they no where mention the "tax-profit" farmer as a factor. If, in fact, the "tax-profit" farmer does exert an economic influence upon land prices, it must fall into a long list of other probably more important factors which these economists have readily identified. The study adds:

> "Per Acre Price . . . From 1947-49 to 1965, the relationship between average per acre land price and volume of land sales was that of an inverse correlation, land prices have consistently increased while the volume of sales has declined.
>
> "Size . . . As a result of large tracts of land being divided and sold in smaller units, the median size land sale in many areas of the state has decreased since 1954. Agricultural use of the smaller tracts of land is primarily that of enlargement of existing farms and ranches. The smaller tracts are also being used for part-time farms, rural homesites, status, investment, speculation, and recreation. In this

type of land market, small tracts with a variety of possible uses usually receive a higher per acre price than large units.

"Mineral Activity . . . Mineral rights influence land prices and land market activity in some areas of the state as evidenced by the fact that sellers retained some or all of the mineral rights in 58 percent of the 1965 land transactions.

"Sales Involving Credit . . . The availability of credit is closely associated with the volume of sales. Easy credit encourages sales while a tightening of credit usually results in a decrease in sales volume. For example, in 1960, 50 percent of the total land transactions were mortgaged. In 1963, 73 percent of the total land transactions were mortgaged, and volume of sales increased approximately 27 percent over the 1960 level. Then in 1965, mortgaged sales accounted for only 60 percent of total sales, and volume of sales decreased approximately 40 percent.

"Interest Rates . . . A change in mortgage interest rates could alter the demand for loans and be reflected in land market activity. Decreasing or low interest rates tend to encourage mortgage loans and increase land market activity. Increasing or high interest rates tend to discourage mortgage loans and restrict land market activity.

"Veterans Land Board . . . Since its beginning, the Veterans Land Board has been responsible for 34,500 land transfers involving 2 million acres of land. . . . In the ranching area of Texas, characterized by large land holdings, the Veterans Land Board is inactive. In other areas of diversified land use, characterized by small land holdings, the Veterans Land Board strengthens the demand for land.

"Land Use . . . A change in land use from traditional agriculture to multiple use or to a higher and better use is usually accompanied by an increase in land value. For example, nearly 28 million acres of land used for agricultural production are also leased for wild game hunting. Multiple use of these acres produces income from both sources, and these lands should command a higher price than comparable land deriving income from only one source.

"Many land markets have felt the impact of the urban demand for land. This impact on land market activity has been reflected through increases in land prices. In some counties located near large metropolitan areas, up to 65 percent of the 1965 land transfers involved out-of-county buyers."

The implication in the concept that "tax-profit" farmers and ranchers are forcing land to extremely high levels is based upon the idea that so-called "bona fide" farmers and ranches must pay higher than economically sound prices for it or are not buying at all. It is true that the rate of increase in land prices has been due to active farmer and non-farmer demands. The Economic Research Service of the U. S. Department of Agriculture released a special study entitled Farm Real Estate Market Developments in December 1968. This publication pointed out that

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farmers represent nearly 2 out of every 3 buyers of land and have bought this land primarily for the enlargement of their operation. They have, in general, tended to be the more progressive operators in their area. In contrast, the nonfarmers which have purchased land have been in the market for investment and other reasons.

Despite the many different motives for entering into the land market, land values still correlate annual returns to land, the same as average dividend yields do with common stock. Land values have appreciated annually at 5.3%, resulting in a total return of 8.8% per year upon sale. The report, in its summary, concludes with this statement:

> "Although local nonfarm demand will influence future land values in many areas, farm real estate price trends will generally bear close resemblance to the economic health of commercial agriculture."

The following quotations appear in the same article:

> "Farm operators, who make nearly 2 out of every 3 purchases of farmland, generally are buying for farm enlargement. Because of the cost-price squeeze,

increased output is one means of maintaining or increasing future income. Acreage expansion can increase production efficiency, particularly in the short run when adequate machinery and family labor are already available. And as long as these fixed costs remain fairly constant with additional acreage, the farm enlargement buyer may economically justify bidding up prices for an add-on unit.

"Enlargement buyers tend to be the more progressive and efficient farm operators in their community.

"Despite the complexity of market forces, the farmland market, in general, remains sensitive to expected economic returns.

"Although yearly increases in land values need bear no relation to annual returns in the short run, price trends do resemble movements in annual returns over time. For 1958-62, residual returns to land averaged around 3.5 percent of market value. Returns in the 1963-67 period were closer to 4.0 percent. Increases in land values showed a similar annual pattern - 4.4 percent in 1958-62 and 6.6 percent in 1963-68.

"Perhaps the most substantial evidence that land values still depend heavily on agricultural returns is presented by regional data. Variations in rates of return among regions in 1966 and 1967 tended to parallel the regional pattern of land price movements. The Delta region, which has had the Lake States region, second only to Mountain States for the smallest increase in land values for the last 5 years, showed one of the lowest average returns to real estate during 1966 and 1967.

> "If past rates of annual appreciation in land prices are considered along with net returns from farm production, the total returns would sufficiently explain the active farmland market of recent years."

This change in value of farmland as it relates more to the productivity of the land is dramatically illustrated by the fact that the major increases in dollar value of farm land have occurred during the last decade in the Delta and the Southeastern States of the United States, the Southern Plains and the Appalachian area. In contrast, some of the smallest gains have been recorded in the Lake States, the Mountain States and in the Corn Belt.

Probably no one statement can better summarize the future of the farmland market than the following paragraph which is taken from the same article:

> "Urban influence will increasingly affect rural land markets. Numerous 'mini-booms' will erupt whenever and wherever rapid urbanization occurs. However, even though industrial and population centers are expanding dramatically, an enormous expanse of farmland will remain untouched by urbanization. Consequently, future value trends for land remaining in agricultural use will probably bear close resemblance to the economic health of commercial agriculture, and will continue to be incluenced by national, agricultural, and economic policy."

The proportion of voluntary sales to total farm real estate transfers has increased quite substantially. In 1955, for example, voluntary sales accounted for 70% of all total farm real estate transfers. By 1960, this figure had increased to over 80% and in 1968 was recorded at about 85%. In contrast, estate settlements and foreclosures have moved to much less significant levels. Farmers and ranchers are thus reaping the benefits of the higher land values and are probably carefully considering this land price appreciation in their total income expectations.

In a more recent issue of the "Farm Real Estate Market Development," (March 1969), under a heading entitled Farmers Dominate the Market, it emphasized that farmers made 59% of the purchases in the farmland market during the year ending March 1, 1968. This article stated:

". . In terms of acreage, active farmers buy 3 acres for every two acres they sell, and therefore are increasing their land holdings.

"Despite dramatic increases in average farm size during the past 2 decades, farmland continues to be bought and sold in relatively small acreages. More than 7 out of 10 transfers in the year ending March 1, 1968, were less than 180 acres.

"Forces on the demand side of the market also encouraged transfer of relatively small tracts -- the most important of these being farm enlargement. Purchases for farm enlargement accounted for 5 percent of sales occurring during the year ending March 1, 1968."

Do High Land Prices Work for or Against the Bona Fide Farmer?

Land is recognized as the principal asset of the American farmer and rancher. According to USDA figures farm real estate represented on March 1, 1968, almost 81% of the total farm assets. Rising farmland values have, of course, forced land into this unique asset position, although it has been the major asset for numerous years. The total value of farm real estate has increased from $130 billion in 1960 to $194 billion in 1968.

This USDA publication emphasizes the extent of bigness already in the industry, that expansion can occur as easily through land rental as purchase, and that the higher land prices provide farmers more credit since land is his principal asset.

The ability of land to serve as a larger credit base which can be used to finance additional land purchases is also brought out by Professor Raup in his article.[11]

Still other concepts of farmland value gains are tied to technological advancement in the society. The following statements are indicative of these ideas:

> "... The evidence, both theoretical and empirical, indicates that the expectation of rising income from technological advance in conjunction with supported farm prices (and from increasing urban demands as well) has been important in contributing to the rise in farmland prices. Expected income increases, because technological advance lowers unit costs and increases individual farm incomes with supported prices, thus providing an incentive to expand farm size, which in turn puts an upward pressure on land prices. Farmland prices rise as many farmers bid for land to capture the gains of technological advance on individual farms thus vanish as the competitive process of acquiring land forces up land prices and absorbs the gains from technological advance.

> "But someone gains. The retiring farmer or landowner who sells farmland at an inflated price reaps the benefits of the technological advance. And this process will continue to push up farmland prices as long as farm prices are relatively stable and the march of technological advance continues."[12]

If as some witnesses before the Ways and Means Committee said, the effect of H.R. 13270 will result in lowering farmland prices, the result would be disasterous. As indicated above, many farmers and ranchers have borrowed funds and pledged their lands as collateral. A reduction in farm land prices would almost certainly mean that many outstanding loans based on increased land value would be in jeopardy and could be called under the terms of most loan agreements because of inadequate security. In turn, this could have the adverse compounding effect of causing businesses in local communities dependent upon farming and ranching to close their doors. The trickle of unemployed from rural to urban communities would increase substantially.

The Ad Valorem Tax Base

The property tax payments so important for local and county government programs, including such essential items as schools and roads, also would be in great danger if, some contend, there would (and should) be a decrease in farmland value as a result of enactment of the House Bill. It is inconceivable that the present local governmental functions could continue with a meaningful reduction in the price of land.

During the past 25 years taxes on farm real estate have increased almost five fold; those taxes have gone primarily to support rural schools, which expenditure does not substantially benefit the non-farm resident. Hence, it is important to note that the farmer residing on the farm benefits as to the cost of education of his children (as well as other benefits) from the infusion of outside capital into property purchases.

VIII. The Competition Allegation

Another complaint before the Ways and Means Committee comes from the assertion that the outside

capital creates unfair competition for the "family" ranch. The idea apparently is that the farmowner with non-farm income in high income brackets does not have to depend on farm operations for a livelihood; the high income bracket taxpayer can demand less for his products than the regular farmer, who needs to make a profit to be able to stay in business.

This assertion cannot stand analysis. <u>There is no set of "farm loss" circumstances under which an economic loss produces a more favorable tax result than an economic profit</u>. The greater the economic profit from a farm, the greater overall economic benefit to the farmer or rancher. If the economic profit of the agricultural enterprise can be increased, the farmer or rancher is financially better off, despite the imposition of income taxes on the farm profit, simply because the increased economic profit is never going to be taxed at 100%.

The fallacy of such assertion comes from the premise that a farmer or rancher will sell his product for less than its market value. There is no evidence to support such illogical, unreasonable course of action.

On the contrary, the livestock industry traditionally is one in which the seller gets all he can in a buyer's market.

IX. Summary

In conclusion, there are certain changes I believe should be made in the Internal Revenue Code to eliminate what I call the "tax-profit" operation.

However, the other proposals in the House Bill (Excess Deduction Account, farm losses in the Limitation on Tax Preferences and the Allocation of Deductions and the so-called hobby loss change) would cause at least two disastrous economic changes to the substantial farmer or rancher. These are: (1) the drying-up of new capital so badly needed in agriculture, and (2) chaos from an impossible accounting situation.

As to the farmland price situation and the alleged improper competition, the facts demonstrate that arguments based thereon for this Bill, or others, cannot, in my opinion, be supported.

Gentlemen, while I am grateful for your attention to my remarks, I appreciate even more your consideration of the problems of the American farmer and rancher in light of federal tax laws and the proposals for changes therein.

1
Although there is a meat import quota, the quota level has never been invoked.

2
Jack Armstrong, "Cattle and Beef Buying, Selling and Pricing Handbook," Purdue University, May 1968.

3
Philip M. Raup, "Land Values and Agricultural Income: A Paradox?" Journal of Farm Economics, December 1965.

4
Gene L. Swackhamer, "Growth of Corporate Farming" Statement before the Colorado Feeder's Association, February 8, 1968.

5
M. L. Upchurch, "Farming and the Rural Scene--Changes in Organization, Opportunities and Problems." A talk presented at the 45th Annual Agricultural Outlook Conference, Washington, D.C., November 14, 1967.

6
Orville L. Freeman, "Science for Better Living," Yearbook of Agriculture, U. S. Department of Agriculture, 1968.

7
Raup, op.cit. note 3.

8
John Donne, "Devotions No. XVII."

9
Petitioner's Brief in United States v. Catto, 384 U.S. 102 (1966).

[10] F. B. Andrews and Alvin B. Wooten, "Trends in the Texas Ranch and Land Market, Texas Agricultural Experiment Station, B1063, Texas A&M University, April, 1967.

[11] Raup, op.cit., note 3.

[12] William E. Martin and Gene L. Jefferies, "Relating Ranch Prices and Grazing Permit Values to Ranch Productivity," Journal of Farm Economics, May, 1966.

EXHIBIT "A"
TECHNICAL DEFICIENCIES IN H. R. 13270

1. It is not clear whether the Excess Deductions Account under the proposed Section 1251 can ever have a negative balance. According to subsection (b)(3):

> "If there is any amount in the excess deductions account at the close of any taxable year (determined before any amount is subtracted under this paragraph for such year) there shall be subtracted from the account - (A) an amount equal to the farm net income for such year . . . ."

Thus it would seem that a negative balance is permitted since the year's farm net income could easily exceed the amount in the account.

If a negative balance in the Excess Deductions Account is intended, the proposed Section 1251 does not appear to allow credit (i.e., subtractions) for profitable years prior to the first year of a farm net loss. The proposed Section 1251(a) states that it "shall apply with respect to any taxable year only if - (1) there is a farm net loss for the taxable year or (2) there is a balance in the Excess Deductions Account as of the close of the taxable year after applying subsection (b)(3)(A)."

In the preceding profit years, there is by definition no farm net loss nor is there any balance in the Excess Deductions Account at the close of any of those taxable years. There is no balance in the account because additions to the account are made for farm net losses (which did not arise) and subtractions are made only if there is an amount already in the Excess Deductions Account.

2. Proposed Section 1251(e)(2) defines "farm net loss" as including those special deductions allowable in respect to land under Sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land). When the net farm loss is added to the Excess Deductions Account, it has the effect of adding a portion of these special land expense deductions with respect to the account. The balance in the Excess Deductions Account will affect the character of gain on sale or exchange of land only to the extent of the land's "potential gain." Proposed Section 1251(c)(2)(C). If no deductions under Sections 175 or 182 have been taken with respect to the land within 5 years, the

"potential gain" in the land is zero (Proposed Section 1251(e)(5)) and thus any gain attributable to those expenses will never be recaptured. Yet such conservation and clearing deductions will remain in the Excess Deductions Account and will convert the capital gain on the sale of some other asset which is totally unrelated to the land, such as breeding stock, into ordinary income.

3. Proposed Section 1251(b)(5)(B) provides that upon the gift of farm recapture property the donor's Excess Deductions Account is transferred to the donee if the potential gain on the farm recapture property given in any one year period exceeds 80% of the potential gain on farm recapture property held by the donor immediately prior to the first of such gifts. This rule appears to lead to unintended hardships for the uninitiated and to be of little effectiveness for the careful planner.

If, for example, a rancher should give half of his ranch (and presumably one-half of the farm recapture property and one-half of the potential gain thereon) to one son, the donee would not be required to take any of

his father's Excess Deductions Account. If more than 12 months later, the rancher gave a second son the remainder of the ranch, that donee would be required to take his father's entire Excess Deductions Account. With careful planning, however, the strictures seem easily avoided. For example, a farmer could give his son an undivided 80% interest in the farm without causing a transfer of his Excess Deductions Account. Twelve months and a day later, he could give the son another undivided 16% (being 80% of the remaining 20% of the original farm). At this point he will have transferred approximately 96% of the original farm without a transfer of the Excess Deductions Account. By waiting another 12 months and a day, the remaining 4% of the original farm could be given to a charitable organization who would then succeed to the entire Excess Deductions Account. The farmer could then again take up farming with no balance in his Excess Deductions Account and the son would have received 96% of the original farm with no transfer of the account.

4. The proposed Section 1251(d)(6) provides

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that in certain transfers of farm recapture property to corporations, the "stock received by a transferor in the exchange shall be farm recapture property." Securities received in the exchange are not so treated. This permits the avoidance of the Excess Deductions Account rules by careful planning. The farm recapture property can be transferred to a corporation for all of its stock and bonds equal to almost all of the value of the transferred property. Such an exchange generally will be tax free under Section 351 of the Internal Revenue Code. The bonds (i.e., "securities") can then be sold and none of the gain thereon would be affected by the balance in the Excess Deductions Account because the bonds are not farm recapture property.

5. The depreciation which contributed to a taxpayer's farm net loss will be included in addition to the Excess Deductions Account. When that depreciable property is sold, the gain equal to that depreciation will be recaptured and treated as ordinary income under the provisions of Section 1245 of

the Internal Revenue Code. Since the tax benefits arising from the depreciation deduction will have been totally eliminated by the sale, there appears to be no reason to leave any of that depreciation deduction in the Excess Deductions Account where it will reduce the amount of capital gains on the sale of some other asset. The depreciation deduction ought not to be recaptured twice.

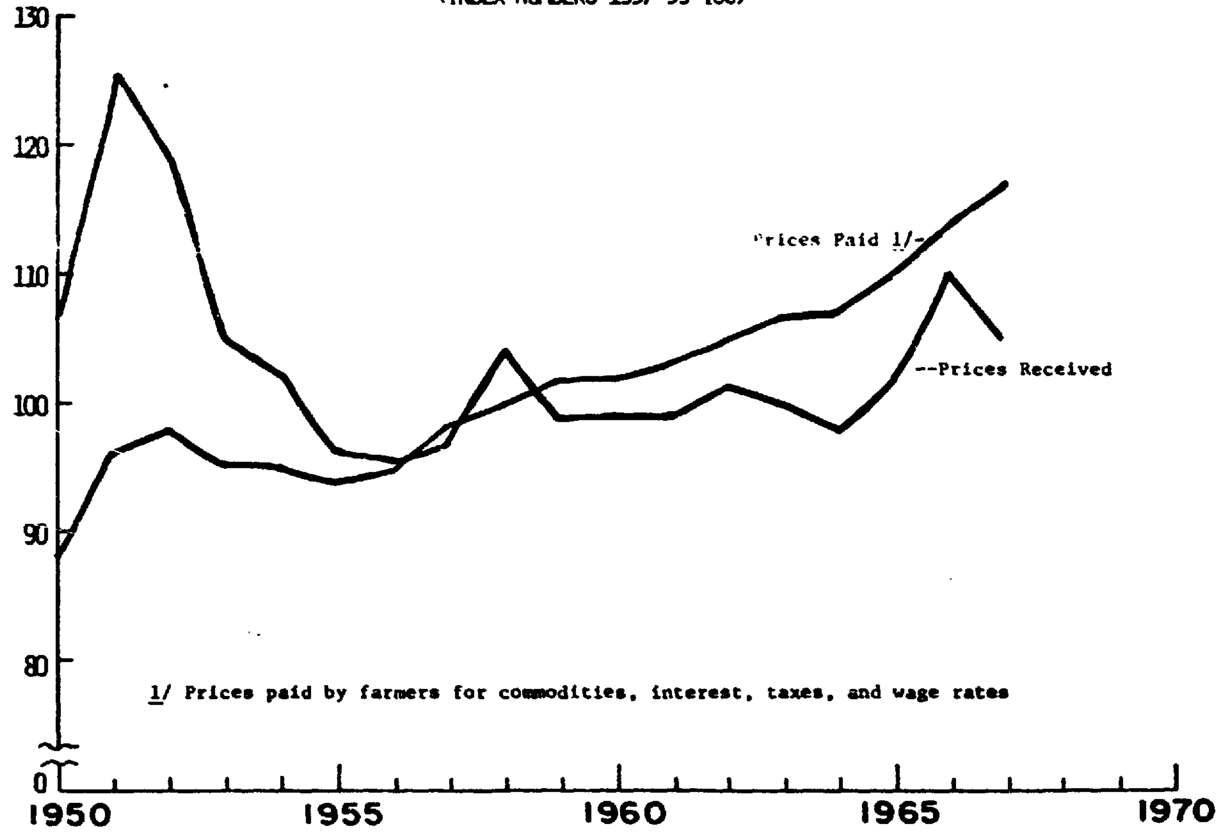
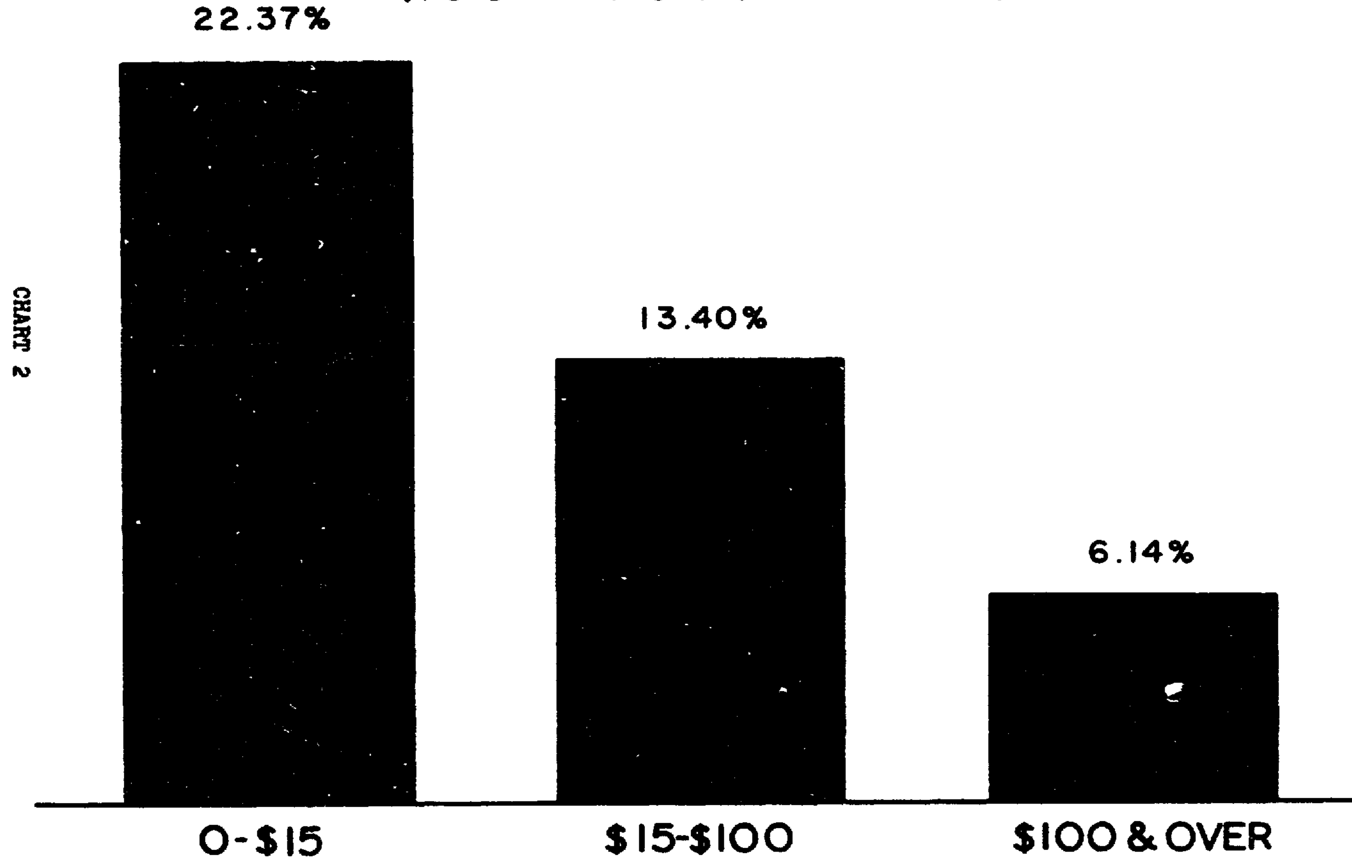


CHART 1

CHART 2



STATEMENT OF GENERAL EARL RUDDER
COLLEGE STATION, TEXAS

WITH RESPECT TO H. R. 13270

Introduction

Gentlemen, while I am the President of the Texas A&M University System, I am also a cattleman, a native of the Southwest, and an individual quite familiar with the problems currently being experienced by agricultural producers of this area of the Nation. Although it would be difficult for me to refrain from the inclusion of some academic material pertinent to the situation, this testimony is offered to you primarily from the viewpoint of these latter positions.

I have been concerned about those individuals who have ranches or farms but apparently intend only to have some type of "tax profit." Certainly no one can defend such individuals as a matter of equity

because it is readily recognized that they would, in fact, have some distorting affect upon the agricultural economy. I am here to try to put the problem into its proper perspective. Certainly some congressional action is warranted, but we should not have the severe economic upheaval due to "over-kill" provisions.

Care must be taken, not only to protect the small farm and ranch operations, but also the larger operations that have provided economical food for the American citizen.

Let us first examine the make-up of the modern American farmer and rancher, the plight he is currently facing, and the benefits which have accrued to the American consumer under the current framework of agriculture which has developed.

The Modern Farmer and Rancher

In order to better understand the type of

agricultural environment in which we are currently operating, let's briefly look at the farmer and rancher of the 1960's. Today's average farmer or rancher is 51.3 years of age, has an average household size of 3.6 persons and has lived on his farm for over 15 years. He has completed 4 years of high school, operates a 351.6 acre farm which has a value of close to $51 thousand, and works about 79 days off the farm each year.[1]

Governor Connally has mentioned the "outside" work and income of the farmer or rancher. I would like to develop this topic further. This work outside of the farm is quite interesting, in that it has become a way of life for most farm families. For example, according to the latest census, 46% of all farm operators in the United States reported some days of work off their farms and 32% reported such work amounted to 100 days or more. There is a significant regional difference in this

proportion too. Almost one-half of the farm operators in the Western region of the country reported some off-farm work while this proportion was 49% in the South and 43% in the North. Of all farm operators working off their farms, 69% reported working 100 days or more, and 56% reported working 200 days or more. In the West, 62% of the operators reporting work off farms, worked 200 days or more, whereas, in the North only 52% reported 200 days or more.

As might be expected, the proportion of farm operators working off the farm and the number of days that they worked varied according to the age of the operators. Sixty-three percent of the operators under 35 years of age reported working off their farms, while 54% of the operators in the 45 to 54 age bracket showed off-the-farm work. In essence, this data merely emphasizes the fact that the modern day farm operator spends a considerably larger proportion of his time working off-the-farm than most people realize.

Not only is off-farm work important in a time aspect - it represents an important source of income to such farmers (Figure 1). In the latest issue of the Farm Income Situation released by the U. S. Department of Agriculture, some rather interesting information is offered regarding net income realized on farms versus off-farm income. The report shows, for example, that in 1968, operations which had less than $2,500 farm sales reported, 85% of the total income of the farm operator's family came from off-the-farm sources. The larger size classifications of farms, those with less than $10,000 farm sales during the year, relied somewhat less upon off-farm income, actually 53% of their total income. Moving to the largest category of farms, those with $40,000 sales or more, off-farm income contributed only 17% to the total farm operator's family income. (See accompanying Tables 1, 2 and 3)

In addition to off-farm part-time employment, supplemental returns from land-based activities such as hunting, fishing, and oil leases contribute significantly to the bona fide farmer or rancher's total family income.

Such activities, to most rural residents, are considered as a part of farm income, although there is a distinction among them for tax purposes. Strangely enough, limitations placed upon the farmers and ranchers with regard to outside income is in direct opposition to the U. S. Department of Agriculture goals and expenditures aimed at stimulating such supplemental income.

In the Yearbook of Agriculture for 1968, Science for Better Living, Secretary Freeman made this statement with regard to non-farm income:

> "Working closely with farmers and other rural people, the U. S. Department of Agriculture is helping to stimulate a rural renaissance.
>
> "Private enterprise is being attracted to the countryside. Rural people, both farm and nonfarm, are taking advantage of government supported opportunities to establish part-time businesses or trades.

> "On thousands of farms, picnic and camp sites, riding stables, game and fishing preserves, winter and water sports facilities have become supplementary and even primary sources of income."

Since agriculture is a highly variable income source, fluctuating with economic conditions in the nation as well as climatic changes, it is also a business enterprise which has tremendous variations in profitability. Net income can sometimes occur, but net deficits are as equally likely. Whenever farm losses do occur, it is obviously to the benefit of the farmer or rancher to use such loss to offset any non-farm income; indeed it is imperative in many cases.

Beef Consumption and Retail Prices

Because of increased production, the development of the commercial cattle feeding industry, and increased efficiency throughout the production and

feeding levels of the cattle industry, beef production in the United States increased from approximately 13 1/2 billion pounds in 1955 to almost 21 billion pounds in 1968. Consumer demands also increased substantially during this period so that per capita consumption was able to increase from 82 pounds per person in 1955 to 109 pounds per person in 1968 without

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any major change in price levels. Some of this increased demand exhibited by the consumer was a result of increased disposable income, although a substantial proportion of it was due to the drastically reduced consumption of other red meats. In fact, during this entire period when beef consumption per person increased 27 pounds, the retail price level for beef showed an increase of only 20 cents per pound. (Figure 2)

Despite this substantial increase in quantity, a rise in beef quality, and almost constantly increasing costs of production, the American consumer has been blessed with an average retail price only slightly higher than that which existed in the mid-1950's. Even a large proportion of this small increase can be traced to the increased demands for consumer services at the retail level in the form of packaging, closer trimming, boning, etc.

Although today's consumers are appalled by the relatively high prices of beef in the retail counter, much of the criticism is really focused at the levels

for the so-called "high-price beef cuts." Unfortunately, all of a beef carcass is not composed of high-price cuts and many "low-price cuts" are often ignored by the consumer picketers. We must remember that only about a quarter of the total beef carcass yields steaks, another quarter roasts, a third quarter miscellaneous cuts such as hamburger, stew meat, etc. and the final quarter of the carcass is lost through shrinkage, cutting loss, and trimmed fat and bones.

Let's spend a minute examining these retail beef prices that have excited some housewives. The United States Department of Agriculture bases its average retail price for beef on prices collected by the Bureau of Labor Statistics. These are basically gathered for use in preparing the consumer price index. The Bureau's purpose is to measure changes in food prices, rather than their absolute levels. Even though the Bureau goes to considerable lengths to obtain a good sample of cities and types of stores in which to gather these prices, the data really offers severe problems for the Department of

Agriculture in that it does not take price specials properly into account.

For example, the advertised price specials that are usually offered on Thursday, Friday and Saturday represent the majority of the retail food sales. Red meat and poultry are the most frequently used items on such sales since they attract people into the store. When the retailer puts a certain cut of beef or broilers on sale during the weekend, the volume of the products sold at these reduced prices is often several times the volume sold at regular prices. Unfortunately, the Bureau of Labor Statistics collects retail food prices on Tuesday, Wednesday and Thursday of the enumeration week, and does not weigh the prices of food according to the specials to reflect this increased volume sold. The average prices reported by the Bureau, therefore, overstate the true average prices of foods. The National Commission on Food Marketing emphasized this error and worked with the Department of Agriculture in an attempt to revise retail prices for red meats and

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poultry in recognition of this problem. In the year 1964, for example, the retail value of Choice beef was reduced 7 cents per pound, for Choice lamb 3.6 cents per pound, for pork 4.1 cents, and for veal 3.8 cents per pound. No data are available with which to compute revised retail prices back into the 1950's, but it can be assumed that there is an overstatement of retail prices occurring back as far as 10 or 15 years. Apparently, however, the use of price specials in supermarkets has increased in the more recent years, so it seems likely that the overstatement is probably greater in the 1960's than it was in the mid-1950's.

Even when this overstatement of the retail prices is ignored, the retail price for beef has shown very little rise during the last 10 to 15 years. (Figure 3) Beef, of course, means cattle, and the prices of high quality fed cattle have reflected about the same basic type of price pattern as the retail beef cuts. The typical rancher, however, does not produce beef, but rather, feeder

calves, that today move into a highly merchandized and specialized cattle feeding industry. This cow-calf producer's output is calves, and they are his only major source of income. Prices received by farmers and ranchers for calves, however, during the last 20 year period have been hardly encouraging.

Texas cattlemen, for example, received an average of $26.27 per hundredweight for live calves in 1968. This represented the highest return from calves, with the exception of the record established in 1951, when prices reached over $30 per hundredweight. (Figure 4) Price levels for calves in Texas have remained within a relatively narrow range ever since the latter 1950's, even though as we have indicated earlier, the costs involved in producing such calves has increased at about the same rate as inflation.

The question, of course, is how can cattle producers pay more for the inputs to produce beef, yet still sell the commodity at relatively the same or even lower levels. The answer to this, of course,

is that they cannot, at least not without losing money. A recent Texas A&M University study indicated, for example, that in order to attain a $3,000 a year return to labor and mangement, it would require an average annual investment of about $4,900 in hog production, about $21,000 for broilers, $48,000 in dairy, and a healthy $112,000 investment to get a $3,100 income from the cattle business.[3]

Similarly low returns were found through a research study of costs of western livestock ranches by the U. S. Department of Agriculture.[4] This analysis deals with actual commercial cow-calf ranches in the Northern Plains, Northern Rocky Mountains, and Southwestern areas of the country, during 1967 and 1968. Returns for the Southwestern ranches were consistently lower and yielded about a $6,000 to $7,000 total return to operator labor, management and capital witn 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	Number of Farms
Farms with Cattle and Calves	2,283,881
Farms with no cows other than milk cows	959,969
Farms with beef cows	1,323,912
Of the 1.3 million farms with beef cows	
-69% had less than 30 head	
-only 3,645 farms had 500 head or more	
-just 1,010 farms had 1,000 head or more	

Expectations for Profit

At this point one should examine the concept of expectations of profits on the assumption all legitimate farmers and ranchers have this attitude.

In the recent Ways and Means Committee report on this Bill, there was a reference to data which indicated that there was a strong trend toward losses increasing as the taxpayers adjusted gross income increases.

Actually, how profitable is the cattle business? Should one really expect huge profits or substantial losses? According to data collected by agricultural

economists at Texas A&M University, it costs an average of about $90.50 to raise a calf, or keep a cow for a year in Texas, if all costs are considered.

This composite average costs is obtained by totaling the various expenses involved in maintaining a cow for one year.[5] (Table 5)

Table 5 - Costs of Keeping A Cow For One Year

Expense	Amount
Land Charge*	$ 28.70
Depreciation	5.60
Interest-herd capital**	10.70
Replacement cost	5.55
Operating costs	39.95
Total	$ 90.50

*Land cost based upon fair lease or rental value.

**Considers cow cost and a portion of the bull.

Note: No charge for labor or management is included.

Let's now look at the returns Texas ranchers probably received during the Report's test year - 1966.

In that year, the Texas calf crop averaged 84%, the average price received for calves was $24.60 per hundredweight and the estimated weaning weight for calves ranged between 350 and 400 pounds. Assuming that our typical cattleman in Texas during 1966 produced a 400 pound calf, sold it for $24.60 per hundredweight, and had an 84% calf crop. Under these conditions, the return per cow would be $82.66. Since our cost estimates, however, were $90.50 per cow, this left the rancher with a net loss of $7.84 per cow during the year.

It is easy to see with these figures that the larger the herd size, the larger the loss would be on any particular operation. Although there may be some economics of scale involved, they are not sufficient enough to change these basic cost figures very substantially. The loss recorded, therefore, of $7.84 per cow during 1966 would mean a $78.40 loss for a 10 cow operation, a $7,840 loss for a 100 cow operation, and a $78,400 loss for a 1,000 cow operation. Thus, our analysis of probable costs

and returns of Texas ranchers in 1966 yields exactly the same type of average loss-size operation relationship as the Report figures. A similar computation of the 1967 statistics indicates that the average Texas rancher realized a net loss of only $4.50 per cow during that year, a substantially better return situation, but still recording a loss.

These loss situations are more common to the cattle businesses of the Southwestern part of the United States. A recent U. S. Department of Agriculture report shows that cattle ranches which operated in the Southwestern part of the United States during the period 1963 to 1967 had considerably higher operating expenses per unit of production than did similar types of ranches in the Northern Plains and the Northern Rocky Mountain region. These operating expenses averaged 25% higher in the Southwest, so that it is more likely for difficulties to arise in maintaining profitable operations in that section of the country than in the other. Also adding to this less favorable

cost situation is a generally lower livestock price level in the South, and consequently smaller returns.

Expectation, according to Webster, is the prospect of the future. Unfortunately, cattlemen are not noted for their ability as fortune tellers. Even the feeding of cattle is highly speculative and very unpredictable. It is not uncommon to experience severe losses for one, two, or even five years in a row and then do much better for the next five. Most of these unprofitable periods are usually felt when the margin between the price paid for feeders and the price received for finished cattle, falls below zero. (Figure 5)

Agriculture, and particularly livestock production, is a highly risky and variable income generator. Not only is the farmer and rancher subject to the elements of nature, but he is also tremendously affected by national situations, economic crises, government programs, and the whims of the American consumer and her demands. No other segment of the economy involves such a wide array of risk and uncertainty, yet at the same time, offers both a short, as well as hazy, planning horizon.

Agriculture Needs Outside Capital for Research

Governor Connally has referred to some of the reasons for the necessity of outside capital. I want to touch on some aspects of the use of capital in agriculture.

It has not been more than about 40 years since agricultural producers of the United States struggled with primitive tools behind a mule to scratch the surface of the earth. The scientific and technological progress of our agriculture has been so rapid that few of us recognize that back in 1937, it required one person employed in agriculture to provide enough food and fiber for 10 persons in the Nation. Yet, by 1967, just 30 years later, one farmer or rancher produced abundantly for more than 40 persons.

No agricultural commodity has shown more progress than that of livestock, particularly cattle production. The first Hereford bull imported in 1817 by the distinguished American statesman, Henry Clay, bears little resemblance to the modern breed of Hereford cattle so prevalent in our country today. Similarly, the first Shorthorn cattle imported in 1783, the original Brahman

stock in 1853, and the initial Angus importations in 1873, held the basic seeds of new breed developments in the United States. Many of these original cattle are hard to identify when reviewing the currently accepted standards of these breeds. Throughout the years since their importation, they have been bred, crossed, and recrossed and now yield superior animals designed to reproduce effectively, gain weight efficiently, and yield carcasses with a high proportion of trimmed retail cuts.

It has been through the efforts of the Agricultural Experiment Stations at land grant institutions such as Texas A & M University, and the U. S. Department of Agriculture that the basic research and extension work was performed. But more than that, it was the brave and industrious cattleman of yesterday using applied research in their own herds who have developed livestock to the point where it now yields more meat, at a reduced cost, with less land, and less manpower than ever in history.

Agricultural research contributions have been

tremendous, particularly when you consider the small amounts of funds devoted to it in relation to other research investments. During 1966, for example, the total agricultural research expenditures by the U. S. Department of Agriculture and the State Agricultural Experiment Stations was $331 million. Industry contributions to agricultural research in that same year were $473 million. Of course, we are talking here about total agricultural research spending, not just research for livestock or cattle. Some idea of the small amount of expenditures devoted exclusively to, say, beef cattle research can be obtained from these comparisons. In 1966, the total budget outlay for the U. S. Department of Agriculture was $5.9 billion, of which only $167 million was spent for research. Beef cattle and related research work, including such things as consumer acceptance, control of insect pests, and economic efficiency in marketing represented only $10.3 million of this total. Another $18.1 million were spent by all the State Agricultural Experiment Stations on beef cattle research, bringing the national

total to only $28.5 million.[6]

At first glance, this figure looks high, but compare it with the research and development expenditures of 1968 for some major corporations: IBM - $410 million; Texas Instruments - $130 million; Xerox - $76.8 million; and Merck - $55.4 million.[7]

Such public research spending is frequently, however, not all that is required. For example, the screwworm infestation of the Southwest was attacked directly by livestock producers who contributed a total of $4 million to help research efforts to erradicate this economically important pest. Recognizing the concern of the producers and encouraged by their financial backing of the project, the government came to the aid of the program with additional funds and assistance. As an administrator at Texas A&M University, I can assure you that contributions to our research efforts are frequently made by producers and often represent the final financial push required for success. Such research contributions by private individuals are usually from the more affluent farmers and ranchers, the ones that can afford such generosity.

An economic study performed in California indicated that not only has such financial support of agricultural research by private groups and individuals been substantial, but that the time lag between the initial phases of the project and the actual accomplishment of the technological advancement, has been shortened considerably through the use of these additional funds:[8]

> Much of the work performed in agricultural experiment stations is subsidized by either industry or government. Research on minor crops may well lag behind other research programs unless some minumum industry support is received to enable purchase of needed equipment, materials and labor inputs.
>
> It would appear logical that given agricultural experiment station research with the minimum backing, then mechanization will be developed sooner or later regardless of industry financial support. At this point, the industry interest is then one of assuring the "sooner" development rather than the "later." Additional financial support would be directed at compressing the probability function to the left, or increasing the probability that the research success would be achieved in a certain number of years or less.

It would be easy for me to claim, at this point, that all the spectacular advancements made in agricultural productivity have been solely due to the university

and government achievements, but this would not recognize the major stumbling block to technological progress - adoption of new technology. Scientists at the institutions and in the research laboratories can experiment and evolve new concepts, techniques and improved varieties. Our extension services then must take this new information out into the field to the producer and show him how to use it. But it requires the cooperation, the field testing, the sacrificing in time and money of the farmer and rancher that produces results and finally develops the new breeds and the modern types. During last year, for example, the Texas Agricultural Extension Service had the cooperative efforts of producers on 4,486 different field demonstrations, of which 1,283 dealt directly with livestock, breeding or feeding.

Agriculture Needs Outside Capital for Development and Expansion

Agriculture is not a self-supporting industry. It requires huge quantities of capital, particularly when we consider the amounts needed to build up a breeding herd or to develop an improved crossbreed.

Fortunately, for us, the tremendous sums of capital required to experiment with new breeds and types has been available in the United States. In many foreign countries, for example, the government is relegated this chore because of the expense and the poor returns on investment. Our livestock producers have been blessed with a realistic Congress which, many years ago, provided some measure of relief for such individuals through somewhat less stringent accounting procedures. The result has been a livestock development in this Nation that far exceeds any other country in the world.

This requirement for high quantities of capital in cattle breed development is emphasized in the Yearbook of Agriculture 1968, issued by the U. S. Department of Agriculture. In a discussion of hybrid vigor and how this was used by corn breeders and later chicken and swine breeders, the author states:

> . . . But cattlemen did not follow their lead immediately.
>
> One good reason for this lag was that cattle breeding stock represents a high investment because much time passes before a new generation reaches breeding

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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, 4 1/2 million acres of cropland, about 3 million acres of which is highly fertile,

will be removed from productive use. Most of this will be land destined to become water reservoirs to service the needs of the rapidly growing population centers as well as agriculture and the remaining million and a half acres will be required for urban development, highways, airports, etc. Our principal resource for agricultural production - land, is becoming scarce.

Our Texas Agricultural Experiment Station operates throughout the State. By virtue of its assigned responsibilities, it represents the focal point of coordination for all agricultural research in the entire State. It is important that this knowledge base be maintained in order to stimulate further agricultural development. Such efforts, however, must be supported by a massive, continuous research, education and extension program - a program combining all the diversified and interdependent strengths of the scientific team expertise that we can muster.

But, the Experiment Station, the Extension Service and the entire University cannot succeed without the efforts and assistance of the dedicated individuals

with the will and desire to try "a new idea." These innovators already realize that it may not lead to glory, nor riches, nor even maybe compensation - only self satisfaction that they have contributed.

Texas A&M University stands ready through its basic team to help meet this formidable and challenging task. Gentlemen, we ask not for your praise, but only for your cooperation in this effort.

1
This data from 1964 Census of Agriculture, U. S. Department of Commerce.

2
Gene L. Swackhamer, "The Growth of Corporate Farming," Statement before the Colorado Cattle Feeders Association on February 8, 1968.

3
Tom E. Prater. "Investment Requirements for an Approximate $3,000 Return to Labor-Management," Texas Agricultural Extension Service, Texas A&M University.

4
Wylie Goodsell and others, Costs and Returns Western Livestock Ranches, 1968, USDA, July 1969.

5
Tom E. Prater. "Estimates on Annual Beef Cow Cost by Areas," Texas Agricultural Extension Service, Texas A&M University.

6
A National Program of Research for Agriculture, Joint publication of the Association of State University and Land Grant Colleges and the U. S. Department of Agriculture.

7
Value Line Selection and Opinion, Vol. XXIV, No. 44, Part 11, August 15, 1969.

8
Samuel H. Logan, "Evaluating Financial Support of Research Programs," Journal of Farm Economics, February 1964.

9
The Budget of the United States Government - Fiscal Year 1969.

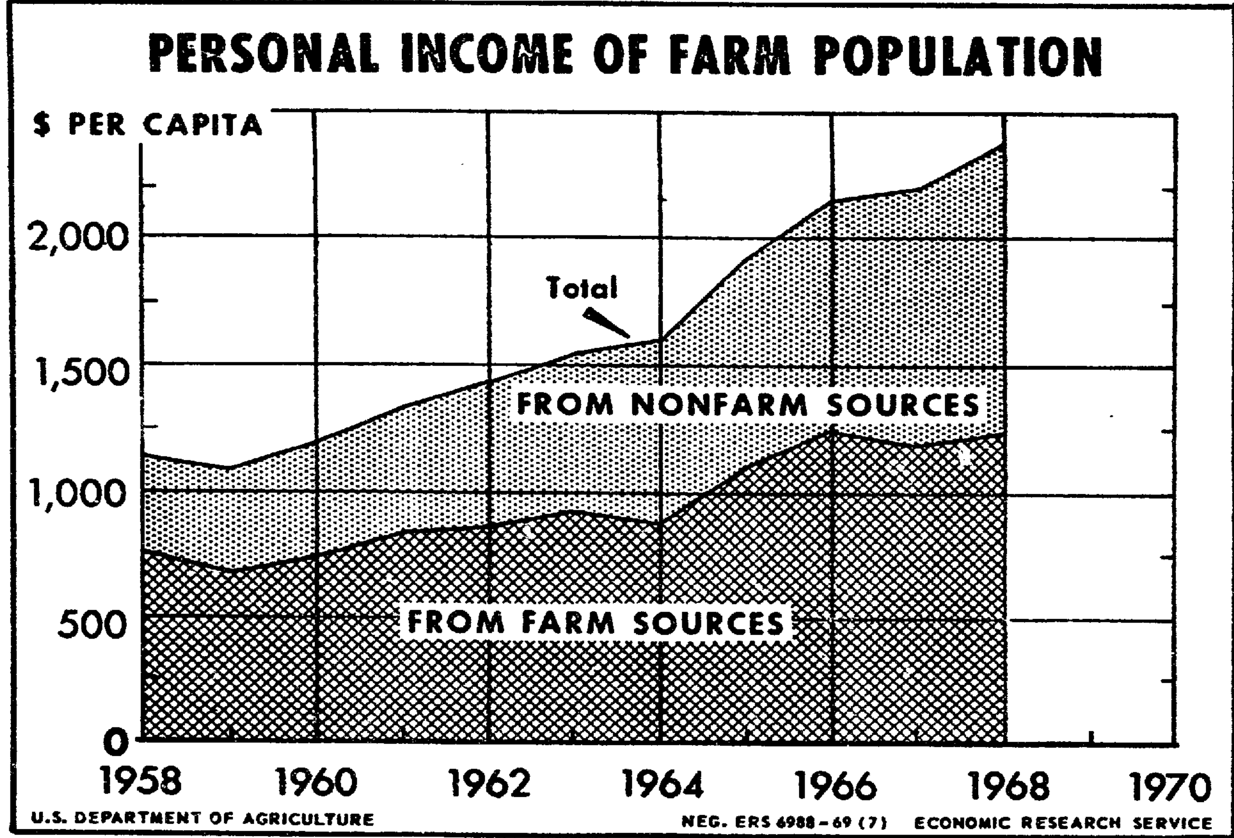

Figure 1

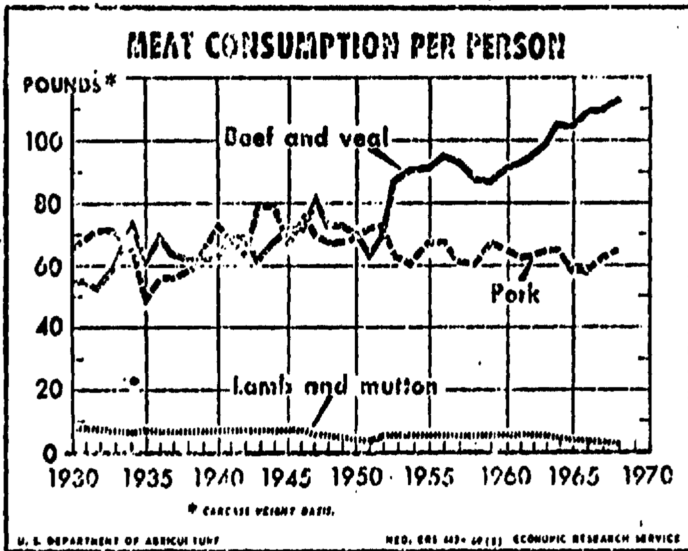

FIGURE 2

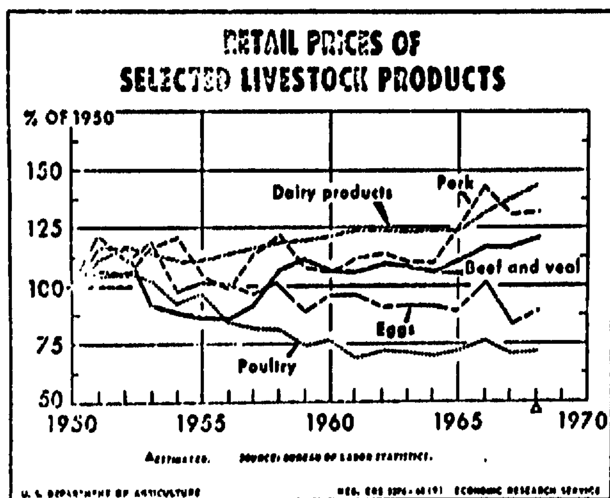

FIGURE 3

MONTHLY DATA

	1963	1964	1965
J	24.70	21.20	19.30
F	23.90	21.60	19.50
M	23.90	21.40	19.80
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	17.90	21.60
N	21.40	18.10	21.40
D	20.60	17.90	22.10

	1966	1967	1968
J	23.40	24.30	24.60
F	25.40	24.80	26.30
M	26.60	24.30	26.50
A	25.20	24.20	27.20
M	24.40	24.20	26.80
J	23.90	25.60	26.60
J	24.30	26.20	27.30
A	25.20	25.50	26.30
S	25.80	25.70	25.60
O	24.00	24.60	25.30
N	23.30	23.80	26.20
D	23.70	24.40	26.50

	1969	1970
J	27.20	
F	29.10	
M		
A		
M		
J		
J		
A		
S		
O		
N		
D		

FIGURE 4

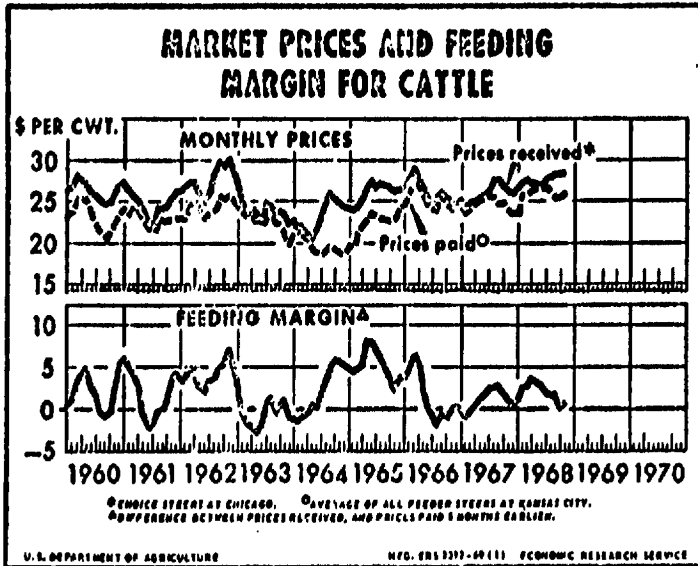

FIGURE 5

Table 1 - Off-farm Income Exceeds Farm Product Value

Tenure of operator	Percent of farm with other income exceeding value of farm products sold	
	1964	1959
Total commercial farm	16.7	12.5
Full owners	24.4	16.9
Part owners	10.5	10.1
Managers	4.5	12.6
All tenants	9.3	7.2
Cash	16.4	13.5
Share-cash	4.2	5.1
Crop-share	8.1	6.5
Livestock-share	4.6	5.6
Other	20.7	10.9

Table 2 - Proportion of farm-operator households having income from off-farm sources

Region	Percent of farms having income from off-the-farm sources exceeding value of farm products sold		
	1964	1959	1954*
United States	38.7	35.8	29.8
North	30.1	28.1	23.1
South	47.4	43.2	34.6
West	41.4	39.5	35.5

* Alaska and Hawaii not included

Table 3 - Farm operated households having off-farm income exceeding the value of farm products

Value of farm Products sold	Percent of farms with other income exceeding value of farm products sold			
	1964	1959*	1954*	1950*
Total	38.7	35.8	29.8	29.1
Under $2,500	76.0	62.5	46.6	43.0
$2,500 to $4,999	33.0	27.2	12.6	10.2
$5,000 to $9,999	9.8	12.6	6.4	5.3
$10,000 or more	1.1	6.5	4.5	4.3

* Alaska and Hawaii not included

SUMMARY OF PRINCIPAL POINTS

Statement of George S. Dillon

on behalf of the

Manufacturing Chemists Association

before the

Senate Finance Committee

on H.R. 13270

September 29, 1969

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 (Sec. 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 (Sec. 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 OF
GEORGE S. DILLON
ON BEHALF OF
THE MANUFACTURING CHEMISTS ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
H.R. 13270 - THE TAX REFORM ACT OF 1969

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 insignificance 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 disproportionately 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.

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 qualifying under this section and has to account for such expenses to his employer.

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 or 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, even though the new principal place of work might be less than 50 miles farther from his former residence than was his former principal place or 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.

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 in 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 ownership 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 ccrporations 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 liquidiations 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 requirement 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 gains 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

SUMMARY OF POINTS MADE BY THOMAS M. EVANS BEFORE THE COMMITTEE ON FINANCE OF THE U. S. SENATE CONCERNING THE TAX REFORM ACT OF 1969

The following is a summary of the three points in the proposed Tax Reform Act of 1969, which are the subject of my testimony and statement.

1) Objection to the disallowance of the use of accelerated depreciation methods with respect to real property as provided in Section 521 of the proposed bill, because when considering the high cost of money, labor and construction materials, all possible means of encouragement should be given to the building business.

2) Objection to the reduced charitable contribution on donative sales as provided in Section 201(c) of the proposed bill, because the changes in the law would not increase government revenues but only decrease charitable giving.

3) Objection to the proposed legislation regarding the breeding business as provided in Section 213 of the proposed bill. Instead, any present abuses could be corrected by providing for recapture of depreciation on sales of breeding animals, in the same manner applied to the sale of machines in the manufacturing business.

WRITTEN STATEMENT OF THOMAS M. EVANS CONCERNING THE TAX REFORM ACT OF 1969

I am Thomas M. Evans, Chairman of Crane Co. and H. K. Porter Company, Inc., and I also operate a horse breeding farm, Buckland Farm, in Gainesville, Virginia.

It seems to me there are a number of serious faults in the House approved 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, factory buildings, etc., 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, i.e., 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

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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.

4. Conclusion

I appreciate the courtesy extended to me by your Committee and I ask that you consider my comments in these three areas in your deliberations in connection with the passage of the Tax Reform Act of 1969.

STATEMENT FOR COMMITTEE ON FINANCE*
UNITED STATES SENATE

RE: H.R. 13270 § 221

FOR DELIVERY MONDAY, SEPTEMBER 29, 1969

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 leglislation.

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

* Submitted by Stanley R. Fimberg, Beverly Hills, California.

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 expense 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 non-deductibility 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 borrowes 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 Thousand 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 164(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 ordinarily 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.

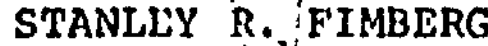
E. Summary.

To summarize, it is respectfully submitted 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).

Respectfully yours,



STANLEY R. FIMBERG

SUMMARY OF STATEMENT OF MR. SIDNEY KESS, PARTNER, ACCOMPANIED BY MR. NEIL WASSNER, MANAGER, MAIN LAFRENTZ & CO., RELATING TO PROPOSED SECTION 411

We feel 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 topple 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 differences in accounting methods between similar companies could lead to dramatic 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.

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STATEMENT OF MR. SIDNEY KESS, PARTNER, ACCOMPANIED BY MR. NEIL WASSNER, MANAGER, MAIN LAFRENTZ & CO., RELATING TO PROPOSED SECTION 411

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 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 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 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 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 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 threshhold 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 apparant 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 disguised 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 myriad 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 Revence 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.

Statement

of

T.F. Dixon Wainwright
Attorney-at-Law
1710 Locust Street
Philadelphia, Pa. 19103

September 29, 1969

To the Senate Finance Committee:

Re: H.R. 13270, Sec. 412(c)
Effective Date of Amendments Regarding
Installment Method of Reporting Gains

Summary

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.

T. F. Dixon Wainwright

T. F. Dixon Wainwright

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BEFORE THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

Statement of S. Rayburn Watkins, President
American Society of Association Executives
concerning H.R. 13270

Summary of Principal Points

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 chanelled 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.

BEFORE THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

Statement of S. Rayburn Watkins, President
American Society of Association Executives
concerning H. R. 13270

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,

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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 non-exempt 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 publisher. 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 fiction 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. Thr commercial

magazines have an entirely different point of view in that they are operated for profit. Our magazines and publications are operated primarily to serve 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 subsection 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 would 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.

Submission of Summary and Statement
Re: Multiple Surtax Exemptions
United States Senate
Finance Committee
September 29, 1969

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 engaged 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 per cent 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 per cent and the one-store corporation a tax of only 22 per cent.

IV. Since testifying before the House Committee the writer has been supplied with facts and figures relating to chain-store 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 communities 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, womans wear, undergarments and hardware.

VI. The writer has also been supplied with data on several other retail specialty chains. One such chain, with sales of $11,619,000 from 87 stores had an average net income per 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 per cent of the stores operating with profits of over $10,000. One chain had more than 93 per cent of its stores making less than $10,000, and four chains had more than 72 per cent 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 per cent, 66 per cent and 67 per cent 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 followed by a phasing out period of 5 years, or simply a straight 10 year phase out of the multiple surtax exemptions.

(d) Increase in equal annual amounts the dividends received deduction from 85 per cent to 100 per cent 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.

PART B—ADDITIONAL STATEMENTS

33-758 O - 69 - No. 13 - 13

CIVIL AERONAUTICS BOARD
WASHINGTON, D.C. 20428

IN REPLY REFER TO:

SEP 26 1969

Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate
Washington, D. C. 20510

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.

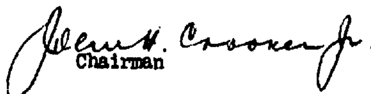
Because H.R. 13270 now excludes air carriers from these new rules, it will not affect the Civil Aeronautics Board's regulatory powers. As you know, the Board differs from most other ratemaking agencies in that its functions include both commercial ratemaking and also subsidy determinations. In commercial 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. CAB, 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,



Chairman

State of Wisconsin \ PUBLIC SERVICE COMMISSION

ARTHUR L. PADRUTT, CHAIRMAN
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HILL FARMS STATE OFFICE BUILDING
MADISON, WISCONSIN 53702

September 23, 1969

FILE NO.

Committee on Finance
United States Senate
New Senate Office Building
Washington, D. C.

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

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

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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 welathy 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 particular 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,

* Submitted by Stephen D. Moses, General Manager

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. Non-residential 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 derpeciation taken after that date in excess of straight line. These rules do not only affect future acquisitions, but apply to transactions entered under the existing 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 to 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 obviously far-reaching 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 non-residential 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.

O